

Annual Report 2004

The period 1 July 2003
to 30 June 2004

Stærðfræði



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INTRODUCTION

The Annual Report of Fjármálaeftirlitið (FME), the Financial Supervisory Authority, in Iceland, presented here gives a summary of FME's activities from 1 July 2003 to 30 June 2004. The Report also discusses trends and the outlook on the Icelandic financial market and gives an account of areas which will be emphasised by FME in the coming year or two. It includes a list of the parties subject to supervision as of 30 June 2004 and explains changes in operating licences of parties subject to supervision during the period covered by the Report. The Report also includes a summary of changes to financial market legislation and regulations during this same period. FME's annual accounts for 2003 are published as the final section of the Report.

As in previous years, FME's Annual Report is published in Icelandic and English. Both versions are available on the FME website, www.fme.is. Please note that the website also includes a variety of information concerning the Icelandic financial market and arrangements for public supervision of financial activities.

FME Board of Directors:

Stefán Svavarsson, Certified Public Accountant, Chairman;
Lárus Finnbogason, Certified Public Accountant, Vice-chairman;
Ingimundur Friðriksson, Deputy Governor of the Central Bank of Iceland.

Alternates:

Benedikt Árnason, Head of Division, Ministry of Industry and Commerce;
Þuríður I. Jónsdóttir, District Court Attorney;
Lilja Steinþórsdóttir, Chief Auditor of the Central Bank of Iceland

Director General: Páll Gunnar Pálsson
Deputy Director General: Ragnar Hafliðason

SURVEY OF ACTIVITIES FROM 1 JULY 2003 TO 30 JUNE 2004

This section provides general information on the activities of the FME during the period from 1 July 2003 to 30 June 2004 as well as touching on matters under consideration prior to the publication of this report.

1.1

Diverse activities

Emphases for the period: Development of FME's performance measurements.

During the period, some 965 cases were registered with the FME (**Table 1**). These cases are varied, ranging from diverse notifications which require relatively little work to more extensive examinations, which may even take up several hundred working hours. Communications received and submitted by the FME on account of these cases were equally multifarious and amount to several thousand.

All employees record their work hours in a special system which is linked to the FME's customer relations management system. The work record provides interesting information concerning the division of disposable time between project categories (**Table 2**).

In 2003, over a third of the work hours at the FME's disposal were spent on various licensing, responses to queries and collaboration. All these projects involve communication which is not initiated by the FME and can, as such, only to a very small extent be controlled by the Authority. This part of the activities is, however, an important aspect of its supervisory functions. Another third of the disposable working time was spent on individual supervisory projects initiated by the FME. This includes regular information gathering, on-site inspections, supervision based on queries (often to a large group of parties subject to supervision) and market surveillance, including the examination of cases concerning the securities market as well as general surveillance activities. It is important to emphasize the importance of such activities.

Nearly 28% of the disposable time was spent on projects relating to the collection of data to provide an overview of individual undertakings and the market as a whole, the development of supervision and a financial market framework, and dissemination of information on the financial market and supervisory activities. Projects of this nature are vital to the operations of the FME.

The work record also provides information on the division of the FME's activities between groups of parties subject to supervision (**Table 3**). This information forms the basis for determining the amounts of supervision fees to be remitted by these parties

Table 1

Various statistics for the period 1 July 2003 to 30 June 2004

Cases opened during the period	965
Letters sent	3131
Letters received	2055
Reports from parties subject to supervision	1766
Inspections based on queries to parties subject to supervision (A single inspection may in some instances include a number of parties subject to supervision at the same time)	35
On-site inspections	50
Queries to the FME, complaints and consumer issues (A number of informal queries is not included)	229

Table 2

Division of disposable hours between FME project categories in 2003*:

Communication: Approval / counselling	37.8	Proportional division(%)
Licensing, comments on licences, approval, validation	13.6	
Responses to queries from parties subject to supervision and their customers	9.2	
Hosting of rulings committees	2.6	
International co-operation	12.4	
Actions initiated by the FME: Operations analysis / corrective measures	34.6	
Supervision based on regularly submitted information (off-site)	7.3	
On-site inspections	14.7	
Supervision based on queries to parties subject to supervision	5.7	
Market surveillance, overview and examination of cases in the securities market	6.9	
Inform / create an overview / develop	27.7	
Overview / data collection	10.0	
Formulation of supervision and framework for the financial market	12.7	
Transparency, the FME website, introductory meetings, electronic publication of annual accounts, annual report, annual meeting	5.0	

**) Recorded hours for management, office work and work scheduling are distributed between individual categories*

Table 3

Division of disposable hours between groups of parties subject to FME supervision in 2003:

Credit undertakings	45.2	Proportional division(%)
Insurance companies and insurance brokers	22.5	
Pension funds	18.2	
Management companies of UCITS	10.6	
Securities firms and securities brokerages	2.7	
Other	0.8	

Statistics on FME actions reveal the weight of its emphasis on preventive measures (**Table 4**). Whilst granting a range of formal licences and statutory approval, the FME has also made sure that certain aspects of the operations of the parties subject to supervision meet the requirements stated in laws, regulations and guidelines intended to reduce the likelihood of mishaps. A large number of decisions taken during the

period, or around 190, are directly related to the extensive changes witnessed by the financial market of late. Another facet of preventive supervision is a range of examinations resulting in remarks, comments and requests for corrective action. The total number of such communications reached 460 during the period. The weight of these communications varies. Some contain reiterated requests for the

Table 4	Number of letters/decisions
Some statistics on FME actions from 1 July 2003 to 30 June 2004	
Licensing (operating licences, qualifying holdings, etc.), approval, etc.	187
Remarks, comments, requests for corrective action (number of letters)	456
Day fines	20
Administrative fines (solely in a limited area of the securities market)	10
Referral to the National Commissioner of the Icelandic Police, according to paragraph 12. of Law No. 89/1998	1
Table 5	
A profile of the FME on 30 June 2004	
Total personnel 35 / total staff positions 33.8	33.8
Thereof (staff positions):	
Business specialists	15.3
Lawyers	8
Actuaries	2
Computer specialists	2
Other specialists	1.7
Office staff	4.8
Average age	41 ár
Average time of employ	8.1 ár
Staff turnover	6.0%

1.2

Qualifying holdings – Operating licences of financial undertakings¹ and insurance companies

Emphases for the period: Supervision of the business conduct of the owners of qualifying holdings. Restraint on the expansion of financial undertakings and insurance companies.

Extensive changes in the ownership of financial undertakings in recent months have resulted in a number of applications to the FME for the purchase of qualifying holdings. Ongoing supervision of the owners of qualifying holdings is also a fundamental aspect and is intended to ensure that the holdings in no respect harm the sound and secure operations of the financial undertaking or insurance company concerned. Supervisory activity concerning the ownership of financial undertakings and insurance companies has primarily dealt with the following:

- The FME received 12 approval applications for the acquisition of qualifying holdings in 7 financial undertakings. A total of 11 applications have been processed on behalf of 6 insurance companies.

- Following an extensive examination of data, most applications for the purchase of qualifying holdings have been approved on the basis of ownership changes, obligation to strengthen specific internal rules within the undertaking, or a statement from the applicants concerning the way in which they intend to make use of their holdings.

- The size of a qualifying holding has in a few instances been investigated, including the question of whether a qualifying holding might have been formed through the relationship between several parties.

- The business conduct of the boards of directors of financial enterprises has also been examined in order to assess the role of the owners of qualifying holdings in the management of the undertakings. This includes whether, and to what extent, statutory internal rules on the role of boards of directors have been introduced and implemented. In this respect it has been examined whether the rules and their implementation meet the minimum requirements set by the FME in its Guidelines no. 1/2003 on Rules pursuant to Article 54, paragraph 2, of Act 161/2002 on Financial Undertakings. Part of the supervision includes regular reports submitted to the FME on special services by financial undertakings to connected parties.

1) Financial undertakings are businesses licensed to operate in accordance with Act 161/2002 on Financial Undertakings. Insurance companies, insurance brokers, pension funds and other parties subject to supervision which are governed by a specific legislation are excluded from this definition.

submission of specific data or information while others accompany reports containing diverse and/or crucial remarks and requests for corrective action to be taken in order to prevent more drastic measures, such as the revocation of operating licences.

Preventive measures as described above render more severe actions less frequent. The final revocation of an operating license is thus relatively rare, whereas remarks, requests for corrective action and preparations for the revocation of a license tend to result in the winding-up of operations, amalgamations, or other important operational changes in order to avoid revocation. Furthermore, it rarely happens as a result of supervisory activities that severe and indictable cases need to be referred to the National Commissioner of the Icelandic Police. Since the FME started its operations, close on twenty cases have received such treatment, which are considered to be serious enough. The FME's authority to impose administrative fines is limited and largely directed towards preventive measures against insider fraud. This authority has been strictly exercised during the period. Day fines are primarily imposed in order to press for the submission of data by parties subject to supervision.

The diverse projects of the FME were carried out last year by a staff of 34 (Table 5). The increased scope of its supervisory activity has been met by effective internal organization, increased experience and clear operational goals.

The increase in projects, partly due to the rapid growth and changes within the financial market, has only to a small extent been met by staff increases. The strength of the FME rests with its employees, but the Authority has had the good fortune of attracting and retaining outstanding employees with qualifications and experience that enhance its functions. The FME also operates a dynamic and effective policy on continuous education.

From the outset, the FME has endeavoured to establish standards for measuring the results of its activities and using the results of such measurements for further improvement and increased efficiency. The ongoing development of such standards was emphasised during the period, for instance by defining critical points for measuring results from supervisory activities and related services, internal organization, personnel matters and the day-to-day management of the Authority. The results of the measurements should indicate whether operational goals and policy formulation have been satisfactorily met. Future goals will then be defined on the basis of the results obtained.

A more detailed account of the development of supervisory activities, internal organization and personnel policy is provided in an Appendix to the Operating Plan for 2005 which will be published on the FME website.

The supervisory activities detailed above help create a profile of individual owners of qualifying holdings, which is then used as a basis for assessing their suitability for future ownership of qualifying holdings.

The extent of the permissible operations of financial undertakings and insurance companies came under the FME's scrutiny during the period. Operational changes within financial undertakings and insurance companies sometimes seem to reflect the emphases of new owners of qualifying holdings. Major projects concerning the operating licenses of financial undertakings and insurance companies are as follows:

- Guidelines no. 1/2004 on the authorisation of commercial banks, savings banks and credit undertakings to participate in business activities were drafted at the beginning of this year. The purpose of the guidelines is to clarify the provisions of Articles 21 and 22 of the Financial Undertakings Act 161/2002 concerning other services, ancillary activities and temporary activities, for instance restructuring investment. The guidelines also contain minimum requirements set by the FME on the preparation of decisions concerning the above-mentioned activities, work procedures, internal control and the submission of information on the activities to the board of directors of the undertaking in question and the FME.
- Regular reporting to the FME by commercial banks, savings banks and credit undertakings on their participation in business activities has been established. Every sixth month the undertakings concerned must supply the FME with a survey of these activities on a special form.
- The operating licenses of insurance companies have, on a few occasions, come under investigation. The FME has raised objections to the financing of motor vehicle loans by insurance companies through borrowing and the extension of an insurance company's lending activities, for instance to investment loans. In addition, remarks have been made on holdings in unrelated businesses where an insurance company is in a position of control as well as requests for corrective action eliminating such control.
- Guidelines on the operating licenses of insurance companies stating the FME's interpretation of legal provisions in this area are currently being drafted.

1.3 Credit market

Emphases for the period: Development of consolidated supervision of international banks. Increased restraint on the capital ratios of financial undertakings. Supervision of large exposures.

The rapid growth and overseas expansion of financial undertakings, in particular the three large commercial banks, and risks resulting from upheavals and growth in the securities market, have been the major concerns of the FME in its supervision of the credit market. The main supervisory activities are as follows.

- Rules on capital adequacy ratios, intended to give increased restraint to financial undertakings, have been formulated. The Rules, no. 530/2004, stipulate the implementation of a recent legal authority to determine higher minimum CARs than the statutory 8% for individual financial undertakings. The rules are based on a specific risk assessment system and stress test developed and used by the FME in its supervisory capacity in recent years. If a financial undertaking fails to meet certain risk assessment criteria, discussions are held between the FME and the undertaking in question on risk assessment and capital position and the corrective action intended on behalf of the management of the undertaking. Following such talks, the FME may request a higher minimum CAR provided there is no other resort.
- The FME has placed an emphasis on introducing the above-mentioned rules to financial undertakings and has had meetings on this issue with most of the savings banks and all commercial banks. A few savings banks are under surveillance as they fail to meet the criteria of the new rules.
- Monitoring of the quality of the loan portfolios of credit undertakings has largely focused on the concentration of large exposures. The question has arisen whether a group of borrowers are connected in such a way that their liabilities may be considered as a single large exposure. In a number of instances, the FME has had reason to suspect that such connections have made the size of the exposure exceed the permissible limits. The FME has entered into extensive communications with individual financial undertakings on account of this and made remarks concerning their risk management.
- Work is currently in progress on strengthening the consolidated supervision of the three major commercial banks, which are increasingly expanding their overseas activities.

The FME insists that financial undertakings have a thorough grasp of risk management on a consolidated basis and has, in this respect, requested that the three major commercial banks produce and maintain detailed descriptions of their consolidated risk management. These descriptions must include a risk analysis for each source of business unit income and subsidiary as well as details of risk assessment and risk management measures. The descriptions will form the basis for a comprehensive risk assessment for the banks in question which is currently being prepared by the FME. The regular submission of information concerning claims and liabilities to overseas parties, itemized by country, has also been established.

- The FME has sought increased collaboration with financial supervisory authorities abroad in order to strengthen its consolidated supervision of the three commercial banks and their subsidiaries. Most of the European authorities as well as the subsidiaries of the banks in the countries concerned were visited during the period. The FME has signed specific contracts (Memoranda of Understanding) with the financial supervisory authorities of Sweden and Finland concerning the supervision of Kaupthing Bank. Preparations for further comparable contracts are under way.
- The purchase by two Icelandic banks of financial undertakings in Denmark and Norway were examined. The FME saw no reason to exercise its legal authority to ban these deals. The FME's decision was based on specific minimum requirements regarding risk management on a consolidated basis.
- Guidelines no. 4/2003 on exemptions from operating auditing departments within financial undertakings were formulated during the period. Smaller financial undertakings may, pursuant to law, apply for exemptions from operating specific internal auditing departments. The guidelines specify criteria on what kind of undertaking may request such an exemption as well as the minimum requirements for internal audit on which the exemption is to be based.
- Guidelines were formulated on the management of foreign currency valued liquid assets. These guidelines are the result of collaborative efforts of the Central Bank of Iceland, the FME and the three major commercial banks.
- Rules on financial statements for credit institutions were reissued with amendments, which included first and foremost increased information requirements, on the one hand

concerning salary and benefits to members boards and CEO's and on the other concerning remuneration granted to auditors. Furthermore, stricter rules regarding loan-loss provisions were introduced.

- Preparations have been made for the introduction of new international rules concerning accounting standards (IAS) and equity (Basel II). The FME has monitored developments and participated in international teamwork in this area.
- As of mid-year 2004 the Housing Financing Fund as a whole has become subject to supervision by the FME instead of its housing bonds division alone. At the same time, the basis for the fund's supervisory rules has been formulated, both in legislation and by a specific regulation. The FME is currently structuring an overview of changes in the fund's risk base, as well as that of other financial undertakings, which are the result of increased competition in the mortgage market.

Supervision of holdings in financial undertakings and their operating licences are discussed in section 1.2 above. The operations of financial undertakings in the securities market are detailed in the following section.

1.4

The securities market

Emphases for the period: Preventive supervision of business conduct in the securities market. Administrative fines. Harmonisation of supervision at European level. Enactment of new legislation on unit trusts and investment funds.

The market surveillance of the FME seeks to strengthen and maintain its overview of activities in the securities market. Through informal collaboration with employees in the securities market, not least compliance officers, efforts are made to support and improve compliance with laws and regulations on securities trading. Individual cases brought to the FME's attention by the market surveillance or the Iceland Stock Exchange are examined. Many of these cases receive a preliminary examination which does not lead to a more formal inspection, while others are subjected to formal examination with ensuing data collection. Formal examinations and measures directed towards specific securities transactions from mid-year 2003 to mid-year 2004 were as follows:

- Investigations were conducted into nine instances of possible insider fraud as defined in Article 44 of the Securities Transactions Act 33/2003. This includes cases involving a

number of parties to specific transactions. One of these cases has been reported to the National Commissioner of the Icelandic Police.

- Investigations were conducted into 2 instances of possible market abuse, cf. Article 41 of the Securities Transactions Act 33/2003.
- In 15 instances it was examined whether primary insiders had failed to notify a compliance officer of an anticipated securities transaction, cf. Article 47 of the Securities Transactions Act 33/2003, but such notifications are part of investigation requirement laid upon insiders, cf. Article 46 of the said Act. In 10 instances the FME imposed administrative fines on primary insiders on account of infringements of this provision.
- In three instances it was examined whether an issuer had notified a regulated securities market of insider trading, cf. Article 47 of Act 33/2003. Administrative fines were imposed in one of these cases.
- Compliance with the notification obligation pursuant to Article 27 of Act 33/2003 was examined in a total of five instances.

During the period, the FME has encouraged improved business conduct in the securities market as a whole. The following is an outline of some of its projects in this area:

- A special introductory meeting for compliance

officers, outlining their role and obligations, was held during the first half of this year.

- On-site inspections were conducted into the work procedures of compliance officers employed by 11 issuers of listed securities. Following these inspections, the FME has forwarded comments, remarks and requests for corrective measures concerning the work procedures of compliance officers and the activities of issuers in this respect. In a few instances, these inspections have resulted in special investigations into possible infringements of the provisions of the Securities Transactions Act and the levying of administrative fines, as explained above.
- A comprehensive on-site inspection was conducted into the conduct of a financial undertaking involved in securities transactions. The inspection resulted in a range of remarks and requests for corrective action concerning the activities of the undertaking in question, for instance in relation to work procedures, the separation of interests, compliance and internal control.
- Guidelines for analysis departments were issued during the period. The guidelines deal with work procedures and the presentation of analyses.
- Discussion paper no. 10/2003 contains draft proposals for guidelines on investor protection,

Insert: Administrative fines in the securities market

The Securities Transactions Act no. 33/2003, which entered into force 1 July 2003, clearly stipulates the FME's authority to impose administrative fines on those who infringe the provisions of Articles 47-51 of the Act. These provisions deal with the work procedures and actions of insiders and issuers of listed securities which are intended to prevent insider fraud and strengthen the credibility of the market.

As stated in section 1.4, the FME has imposed administrative fines in a total of 10 instances. The fines were imposed on a primary insider, individual or legal person for non-compliance with the obligation to notify a compliance officer, pursuant to Article 47 of Act 33/2003. Fines ranged from ISK 50,000 to ISK 750,000, but according to Article 54, paragraph 1, of the Securities Transactions Act the administrative fines may be from ISK 10,000 to ISK 2 million

Six of these cases have been referred to an appeals committee, but five of those concerned the transactions of primary insiders within a single listed company. In three of these cases, the appeals committee dismissed the FME's decision, but the complainant maintained that the CEO of the listed undertaking concerned had appointed a deputy compliance officer who had been notified of the transaction. This justification was only put forward after a decision to levy administrative fines had been made and was not supported by any data from the issuer. The appeals committee ruled that the FME had not provided conclusive evidence to the effect that the deputy compliance officer had not been appointed.

One case was dismissed by the appeals committee on the grounds that it could not be clearly deduced from Icelandic law that compliance officers may not authorise transactions in their own name even though the committee agreed with FME that such an arrangement is aberrant.

In the other two cases, the appeals committee confirmed the FME's decision on administrative fines and dismissed the complainant's justifications, which were partly based on an interpretation of Article 47. On the other hand, the appeals committee reduced the amount of the fine based on the consideration that the fine should not reflect the amounts involved in the transactions in question.

In its rulings, the appeals committee also made certain remarks concerning the preparation of the above-mentioned decisions. The FME intends to make a thorough study of these comments in order to strengthen its future handling of such cases.

which deal with a range of issues concerning the services of financial undertakings to their customers. The guidelines are currently being finalized, but their introduction was delayed as the content of the original discussion paper partly overlapped with the launch of directives for the securities market.

The FME has examined 15 instances of suspected offers to the public of financial services for which the party concerned had no official licence according to the current legislation on financial undertakings. On nine occasions the FME has published an official warning on account of such activities, as provided for by Article 102 of Act 161/2002 on Financial Undertakings.

The Act on Undertakings for Collective Investment in Transferable Securities (UCITS) and Investment Funds no. 30/2003 entered into effect during the period. Some of the projects concerning its implementation are listed below:

- Five management companies of UCITS were granted operating licences pursuant to the new Act. The processing of the applications for operating licences was thorough, as the applicants carried out various changes and improvements as recommended by the FME.
- The FME formulated Guidelines no. 5/2003 on the separation of management and depository operations and the independence of the management companies of UCITS pursuant to Article 15 of Act 30/2003. The FME also published two discussion papers: no. 14/2003 on separation and conflict of interests within the management companies of UCITS, and no. 2/2004 on draft proposals for guidelines on the content of prospectus summaries.
- On-site inspections were conducted into specific areas of the operations of three management companies of UCITS.
- Monitoring has taken place of the activities of a few investment companies and funds that have not yet applied for operating licences pursuant to Act 30/2003 in order to establish whether their operations fall within the scope of the legislation and they must thus apply for operating licences.

Considerable time and effort has been spent on the implementation of new directives for the securities market, such as the directive on market fraud and the directive on prospectuses. Provisions concerning the takeover of listed undertakings have also been reviewed. The FME has participated in this work which is directed by the Ministry of Commerce.

1.5

The pension savings market

Emphases for the period: More on-site inspections. Improved risk management.

Icelandic pension funds have in recent years been recovering after a difficult period of negligible investment return. The FME has emphasized that the pension funds reflect on this experience and use it as a basis for improved risk management. The FME's supervisory tasks during the period included the following:

- Five on-site inspections of pension funds were conducted during the period. Remarks, comments and requests for corrective action as a result of these inspections vary, but deal for the most part with pension fund investment, commitments and their evaluation, internal control, major work procedures and submission of reports to the FME.
- Nine investigations were conducted into pension fund investments. These investigations have focused on the breakdown of investments, but the pension funds' internal control systems, annual accounts, auditors' reports and investment policies have also been examined. Remarks and requests for corrective action are largely pertaining to investments in unlisted securities, securities issued by a single party and overall investment in individual UCITS. Pension fund investment is generally much more in line with the limits fixed by legal provisions, as well as the pension funds themselves, than in previous years. For most of the pension funds examined it was necessary to remark upon a number of factors concerning internal control.
- Remarks have been made on the annual accounts of a few pension funds and in one instance it was requested that the annual accounts be reviewed and republished. This decision was referred to the appeals committee, but its ruling is as yet not available.
- Around 20 pension funds amended their Articles of Association during the period, some on account of curtailments of rights. Curtailments of rights were, however, fewer in this period than in previous years owing to a general recovery in the actuarial positions of the funds. The FME delivers its opinion on each amendment to the Ministry of Finance. In some instances, the opinion of the FME is sought prior to the submission of the amendments for ratification by the Ministry.
- Examinations of the actuarial positions of pension funds have been conducted parallel to the on-site inspections mentioned above and amendments to the Articles of Association.

Considerable time and effort has been spent on implementing new forms for the results of actuarial surveys, which were introduced in 2003.

- On four occasions the FME delivered its opinion on rules concerning supplementary pension coverage to the Ministry. The depositories of supplementary pension savings are also increasingly seeking the assistance of the FME as regards changes to their contract forms, although these do not constitute changes to their rules.
- A few instances concerning management and separation between the sale of supplementary pension coverage and other depository activities have been examined. Competition in this field has increased considerably in recent months and it is of utmost importance that service providers pay serious attention to their conduct towards customers.
- During the latter half of 2003 the FME invited the executive boards of pension funds to attend meetings to discuss the responsibility and obligations of board members, internal control, exposures and risk management.

1.6

The insurance market

Emphases for the period: Improved risk management. Supervision of technical provisions. Improved conduct in the sale of insurance.

The insurance market has experienced its share of the upheavals in the financial market and the effects of these upheavals have made their mark on the FME's projects. In addition to routine activities, the FME's supervision of the insurance market has included the following:

- Some organisational changes were carried out by parties under FME's supervision in the insurance market. Sjóvá-Almennar tryggingar hf. is now part of the Íslandsbanki group and a new insurance company, Vörður váttryggingafélag hf., received its operating licence and took over the insurance base of Vörður Váttryggingafélag g.t. Another insurance company, European Risk Insurance Company hf. was issued with a licence for general liability insurance, but the company intends to operate mainly in UK. Vélbátaabyrgðarfélag Ísfirðinga was dissolved after all its insurance contracts had been diverted elsewhere. Three insurance brokers were issued with operating licences and five brokers ceased operating.

- The results of an examination of the premiums for mandatory motor vehicle insurance were published earlier this year. The examination focused on whether the premiums charged by the insurance companies were fair on the policyholders and in keeping with insurance risk and normal operating expenses. The status of technical provisions at three of the largest insurance companies was especially examined. The results indicate that technical provisions have been overestimated through the years, but also that this practice has been somewhat reversed of late due to improved claims assessment procedures and increased restraint. These improvements have resulted in higher profits for the insurance companies and recent reductions in premiums. The FME was not in a position to request a lowering of premiums, but pointed out that there was scope for further markdown in this area. More details about these results can be found in a news announcement from 11 June 2004, published on the FME website.
- Property insurance premiums have come under scrutiny, especially with a view to price increases at year-end 2002 and subsequent developments in this branch of insurance. The examination is now in its final stages.
- Work was continued on formulating new rules for assessing technical provisions and the submission of accompanying documents. The new rules aim firstly to establish general rules of procedure through harmonisation of work methods; secondly, that there exist observable criteria for assessing technical provisions and, thirdly, to increase the amount of information on technical provisions supplied by the insurance companies to the FME.
- The activities of smaller insurance companies are supervised on a regular basis, as it is important to pay close attention to the financial position of fledgling companies and the structuring of their technical provisions.
- Competition in the area of mandatory motor vehicle insurance has been monitored, especially with regard to deviations from the published tariff and bonus rules. The FME has suggested to the insurance companies that premium reductions of this nature be made more general. The FME has also drawn attention to its Guidelines no. 5/2002 on the bonus rules of insurers in compulsory motor vehicle insurance and reiterated that the insurance companies must keep to their own system and guidelines for bonus rules, or else introduce new procedures.

- During the period, the FME conducted an assessment of the competence of six individuals who had been employed as chief executive officers of insurance companies or insurance brokerages. This is an oral examination of the individual's knowledge of the subject. Aptitude tests of this nature will be introduced in the future for employees in other areas of the financial market.
- In order to encourage dialogue on the risk management of insurance companies, the FME has increased its regular communications with the managements of insurance companies. The FME has also completed on-site inspections of the risk management systems and internal control of five insurance companies and five insurance brokerages.
- Guidelines no. 6/2003 on the conduct of insurance salesmen were published during the period. They are comparable to Guidelines no. 7/2002 on the working procedures of independent insurance brokers. Discussions relating to supervision of ownership within the insurance market and their operating licenses can be found in Chapter 1.2.

1.7 International co-operation

Emphasis: Harmonisation of supervision and regulation within the European Economic Area strengthens the sensible overseas expansion of domestic undertakings.

The FME has continued to stress the importance of harmonising its supervisory framework for the financial market with that of our neighbouring countries. The following projects are examples of this emphasis:

- The FME has strengthened its collaboration with parallel institutions in countries where Icelandic commercial banks have established themselves, either directly or through subsidiaries holding operating licences in those countries. This includes, for instance, special Memoranda of Understanding between the FME and the financial supervisory authorities of Finland and Sweden concerning the supervision of Kaupthing Bank.
- The FME is an active member of joint committees of European financial supervisory authorities which have the function of harmonising supervision in the financial market and thus supporting an effective internal market within the EEA. The committees also serve as advisory bodies to the European Com-

mission on the formulation of a harmonised legislation for the financial market. The committees are CESR (Committee of European Securities Regulators), CEBS (Committee of European Banking Supervisors) and CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors).

Further details on international co-operation can be found on the FME website.

1.8 FME operations

For the year 2003 the FME's expenses, including the purchase of assets, amounted to a total of ISK 256.9 million. Income for the year, including interest income, came to ISK 263.0 million, of which income from supervision fees was ISK 259.8 million. This gives an operating surplus of ISK 6.1 million for the year 2003. The above figures do not include expenses and income arising from the Complaints Committees which are hosted by the FME. At the beginning of 2003 the FME's capital was negative by ISK 1.3 million. This was taken into account when calculating the amount of the supervision fee for the year 2004, which was then approved by Althingi. The income for 2003 was allocated back into the FME's operations during the year. The operating surplus created a capital of isk 4.7 million, or 1.8% of the Authority's net income.

According to the FME's reviewed operating plan for 2004, operating costs for the year are expected to total ISK 288.7 million. Income, including interest income, is expected to be ISK 292.5 million, of which income from supervision fees should be ISK 289.5 million. Income in excess of expenses is thus expected to reach ISK 3.7 million. Given the positive equity of ISK 4.8 million at the beginning of 2003, an operational surplus of ISK 8.5 million is envisaged to be carried forward to the operating plan for 2005.

The operating plan for 2005 has been presented to the Minister of Commerce as provided for by law. The plan estimates an increase in the scope of operations by 7.2% over the previous year. Expenses are expected to amount to ISK 309.5 million and income, including financial income, to be ISK 301.0 million, of which the levied supervision fees for 2005 should reach around 298.0 million.

2

THE FINANCIAL MARKET – TRENDS AND OUTLOOK

2.1

The credit market

Good performance

During 2003 and the first half of 2004, the return on equity (ROE) of deposit institutions was very high. Their good profitability can be explained in particular by unusually high income as a result of substantial trading gains and also by income other than fees and commissions. Trading gains are primarily the result of favourable price developments for both shares and market bonds on the securities market. This good performance can also be attributed to improved cost utilisation, as indicated in the dropping cost ratios, while the volume of their activities has increased substantially. The high profitability of deposit institutions in the past year or two is thus based to a considerable extent on income which must be expected to fluctuate significantly from one year to the next. On the other hand, the income base is now broader, especially as far as the large commercial banks are concerned, in part due to their increased activities outside of Iceland.

Substantial lending increase

Since the end of 2002, deposit institutions' lending growth has been substantial; during the first half of 2004, the 12-month increase in lending has exceeded 30%. Part of this increase is lending to foreign parties. The sizeable increase is cause for concern, as experience has shown that increased credit losses can be expected in the wake of rapid lending growth. It is also worrying that a substantial portion of this lending increase is financed through foreign borrowing. A rapid increase in lending is also among the risk factors which can foreshadow difficulties in the financial system.

According to the available indications on the quality of the bank's loan portfolios, however, there is little reason to regard them as other than acceptable in comparison to previous years, based, on the one hand, on developments in loan defaults and, on the other, in non-performing loans and appropriated assets. Any statements concerning loan quality, however, must be qualified by the admission that there is as yet scant experience of the repayment of recently granted loans. Furthermore, it is clear that a good proportion of the lending increase in the past year or two is connected with changes in ownership and restructuring of enterprises. In such instances the loans are primarily guaranteed with shares in the companies concerned and the risk thus equivalent to share risk.

Substantial assets in market securities

Deposit institutions' holdings of market bonds and shares have grown substantially in recent years, especially their equity holdings. As a proportion of their capital base, however, the increased share assets are insubstantial and there has actually been a decrease in the case of market bonds in the past 3-4 years. Going back still farther, however, the picture was quite different and assets in market securities were an insignificant part of the equity of deposit institutions. Developments over the past decade reflect the major restructuring of the activities of deposit institutions which has taken place in Iceland. As a result of the changes, the companies' risk exposure has increased substantially, placing greater demands than before on their managements to set objectives for effective control of exposures and risks.

Increased activities – greater importance for the Icelandic economy

The past 10 years have witnessed a complete transformation in the scope of deposit institutions' activities in Iceland. At the beginning of this period, their balance sheet outcomes totalled around ISK 300 billion (bn), while at the end of it the figure was close to ISK 2,000 bn. If these amounts are expressed as a proportion of GDP, the ratio in the former instance is 70% and in the latter 215% (230% for groups), a clear indication of the major change which has taken place. The changes can only to a limited extent be explained by the activities of deposit institutions through their subsidiaries abroad. A major increase in the activities abroad is on the horizon, however, with the inclusion of the Danish bank FIH in Kaupthing Bank's consolidated accounts. These figures also indicate the increased importance of deposit institutions for the Icelandic economy and that any setbacks which the operations of these financial undertakings could possibly suffer would have considerably greater impact than previously.

Changed financing

In parallel to the above development in deposit institutions' activities, a noteworthy change has occurred in the composition of their financing. During this same decade the share of deposits in their balance sheet outcome has dropped from 50% to 30%, while the share of other debts and obligations has increased from 40% to 63%,

primarily in the form of foreign borrowing. This applies in particular to developments in the commercial banks' financing, and less to that of savings banks, as the proportion of deposits in their financing has remained fairly steady during the past decade. The tendency towards increased foreign financing of deposit institutions brings with it a variety of additional risks. Experience has shown that deposits are a much more stable form of financing than borrowings which have a pre-determined due date for repayment. Borrowing involves a substantial refinancing risk, both due to the relatively short term of such loans as a rule and because a major portion of this borrowing is obtained from foreign markets.

The above-mentioned growth in balance sheet outcomes has been accompanied by a similar development in the book value of deposit institutions' equity, which has grown from ISK 30 bn at year-end 1995 to over ISK 140 bn at the end of June 2004, or from 7% of GDP to 17%. This equity trend reflects the increased possibilities which have opened up for service to the steadily expanding operations of Icelandic corporations during the period in question.

The equity position must reflect the exposures of the party concerned

The overall capital adequacy ratio (CAR) of Iceland's commercial banks and largest savings banks, calculated in accordance with the capital adequacy provisions of the Act on Financial Undertakings, has been rising since the end of 2000. At the end of June 2004, it was just over 13%. The minimum ratio allowed, based on the stress test using the references set in FME's rules on a higher CAD ratio, was 10.3%, but these references assume a 25% reduction to the book value of shares held at own risk, 7% reduction to the value of market bonds held at own risk and 20% reduction to the value of non-performing loans and appropriated assets. Other CARs, i.e. the ratio of Tier 1 capital and the ratio excluding subordinated loans, have developed in a similar manner to the CAD ratio, see *Figure 11*.

Recently the largest commercial bank has had a very high CAD ratio, in part due to anticipated investments in foreign financial enterprises. Due to its singular position and the heavy weighting of Kaupthing Bank (previously Kaupthing and Búnaðarbanki) in the total figures for deposit institutions, the figures mentioned above do

not present a true picture of the situation among deposit institutions in general. The development of the CARs of the country's commercial banks and largest savings banks, excluding Kaupthing Bank, indicates that their overall CAD ratio has dropped since the end of 2002, when this was just over 12%. At the end of June 2004 this ratio was 11%; based on the previously mentioned stress test, the minimum ratio allowed is just under 10% (figure 12). Of the 10 deposit institutions included in the above figures, two are slightly below the level prescribed for the stress test. The development of other CARs of deposit institutions, excluding Kaupthing Bank, i.e. the ratio of Tier 1 capital and equity ratio excluding subordinated loans, is similar to the CAD ratio, with the difference, however, that these ratios have risen slightly, by about 0.3-0.4 percentage points during the first half of this year and are currently 8.7% and 8.3% respectively.

On the whole, having regard to the previously mentioned stress test, the CARs of the commercial banks and largest savings banks appear to be acceptable. It is being reassessed, however, whether the stress test assumption of discounting the value of shares by 25% is sufficient, in view of the major increases in share prices which have occurred recently.

Developments ahead

Considerable changes are foreseeable in the scope of financial undertakings' activities, primarily involving increased operations abroad. This applies in particular to the three largest commercial banks. Furthermore, mergers and restructuring can be expected in the savings bank sector. In addition, further merging of enterprises into larger operating units can be expected to affect the financial undertakings' capacity to provide them with satisfactory services, for instance, having regard to rules on

the limits for large exposures. In this connection, the focus will increasingly be on how borrowers are connected internally, in the understanding of the relevant rules. An increase in the share of commercial and savings banks and other financial undertakings in housing mortgage loans is also foreseeable. The above changes will result in a variety of new opportunities and income possibilities for financial undertakings, together with new and different risks which must be monitored. Extensive changes to the regulatory framework for financial undertakings are also in the pipeline, on the one hand, with the introduction of new international accounting standards as of the year 2005 and, on the other, with new, Basel II rules on capital adequacy which will come into effect as of 2007. The changes to the regulatory framework will mean, for instance, increased demands for risk assessment, risk management and internal control, and information disclosure on risk.

Figure 1

ROE of commercial banks and largest savings banks based on different weightings of operating income

Return on equity (ROE) on an annual basis for commercial banks and the largest savings banks. ROE I shows profit as shown in annual accounts, ROE II is profit net of trading gains and ROE III profit net of operating income other than fees and commissions. In calculating ROE II and III, no consideration has been had for the impact of lower interest cost and taxes due to assumptions concerning lower income, with the result that ROE II and III are underestimated to some extent.

— ROE I
— ROE II
— ROE III

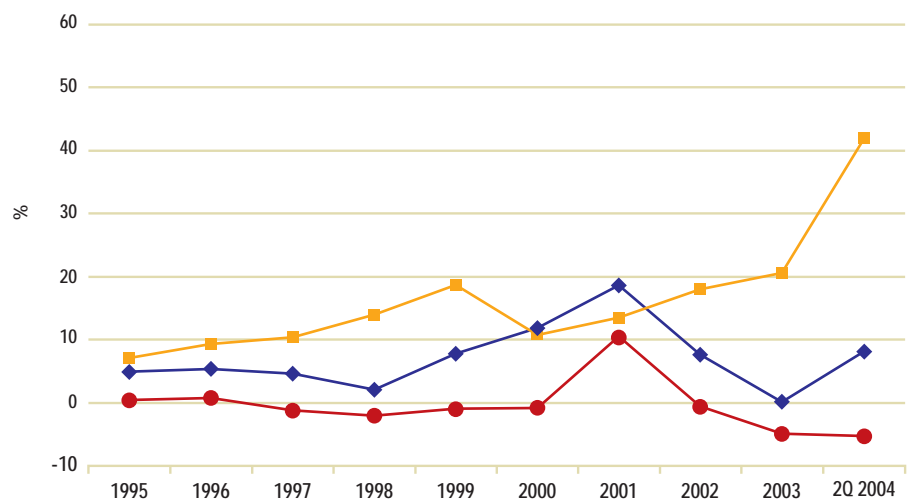


Figure 2

Main operating items of commercial and savings banks as a proportion of their total assets

The development of major operating items of commercial banks and the largest savings banks as a proportion of their average total assets. Figures for the 1st half of 2004 are extrapolated to an annual basis. The interest rate margin and operating expenses have decreased almost steadily during the period. Provisions for credit losses appear to increase slightly during the latter half of the period up until the first half of 2004. The development of non-interest income, however, differs significantly from that of other operating items. Non-interest income has grown steeply and steadily since 2001, following the downturn of the preceding years.

— Operating expenses — Non-interest income
— Net interest income — Provisions for credit losses

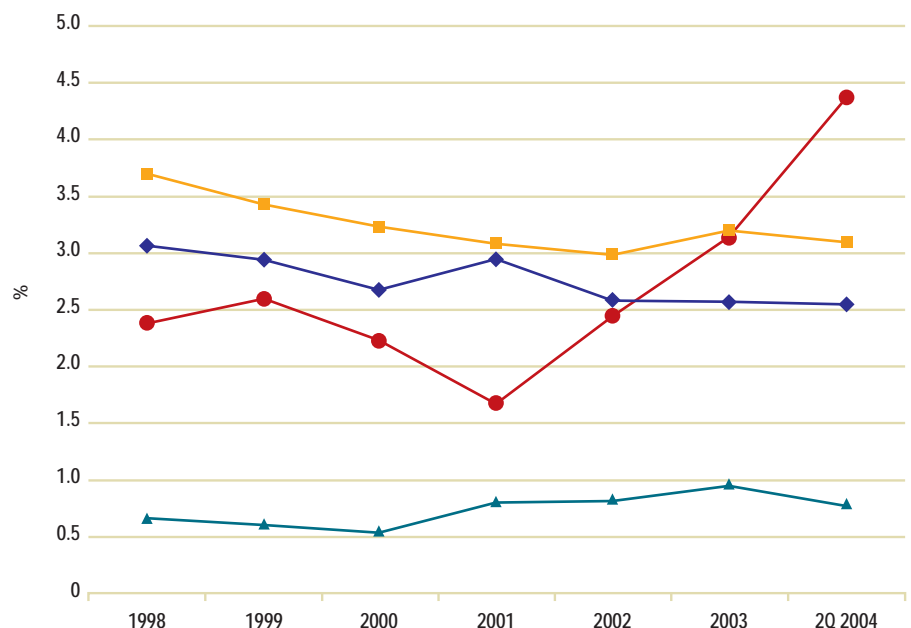


Figure 3

Total loans of deposit institutions and 12-month nominal increases in loans

The total lending by deposit institutions at end of period and the 12-month increase in lending by these institutions (parent companies only). As is clear from the figure, lending growth has been substantial in recent years.

■ Loans
◆ 12-month nominal increase in loans

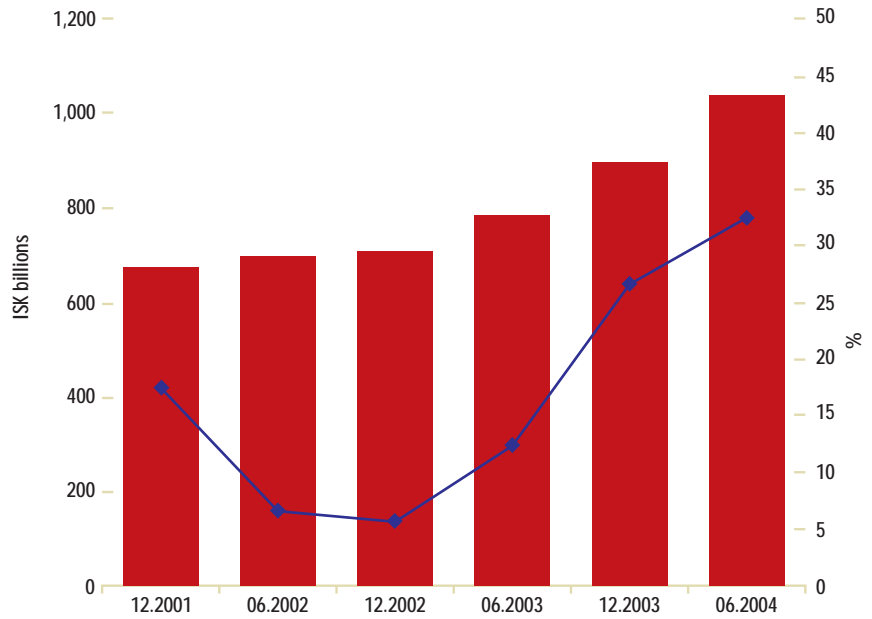


Figure 4

Defaults to deposit institutions in ISK millions and as a % of total loans one year earlier/with a one-year lag (payments over one month past due)

Defaults to deposit institutions (parent companies only) at the end of each quarter since year-end 2001 in absolute terms and as a proportion of total loans one year earlier. The figure shows that since the latter half of 2003 defaults have decreased and are close to a minimum at the end of Q2 of 2004.

■ Payments past due > 1 month
■ % of total loans

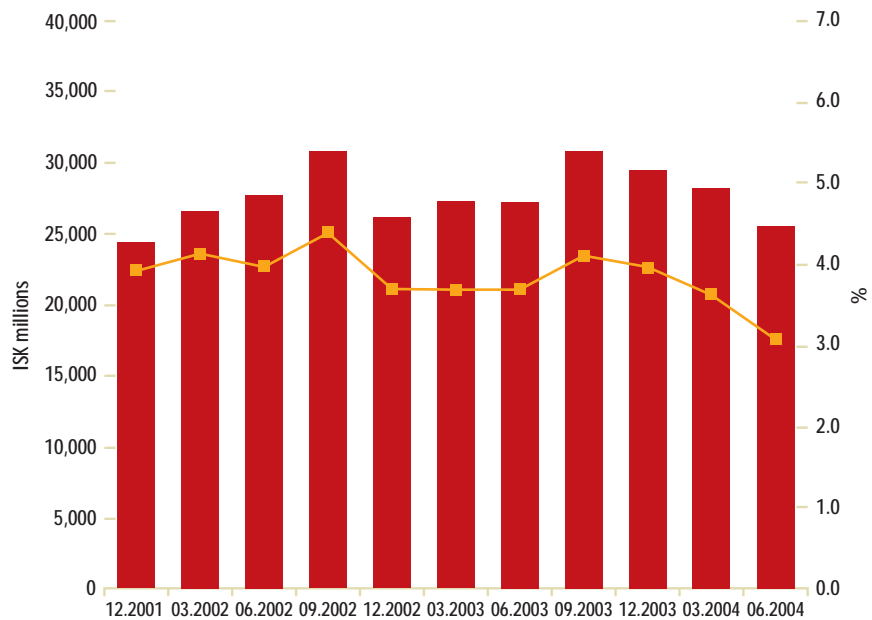
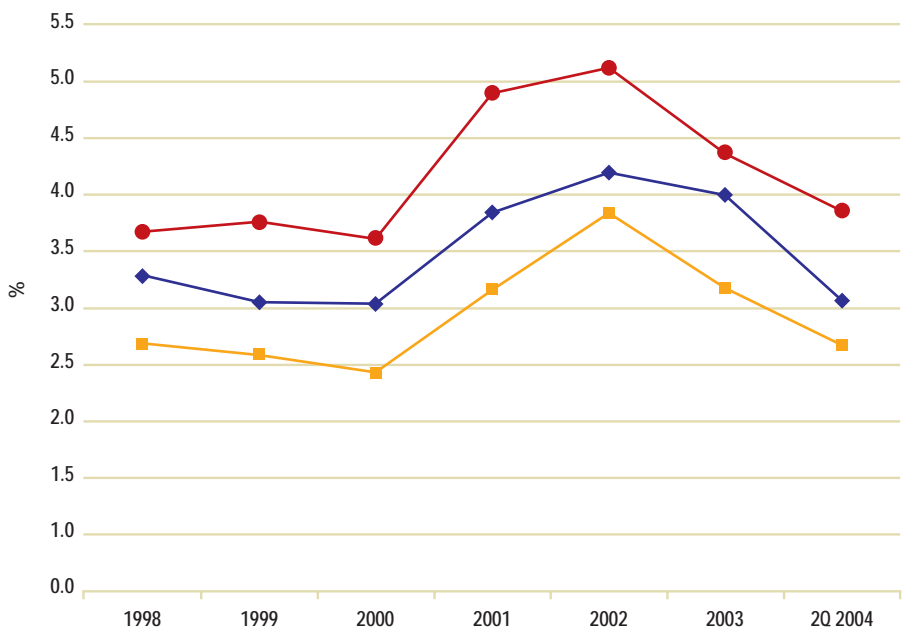


Figure 5

Non-performing loans and appropriated assets as a proportion of loans

Non-performing loans and appropriated assets in the consolidated accounts of commercial banks and the largest savings banks as a proportion of total lending. The figure shows the steadily dropping proportion since year-end 2002, when these items reached a relative peak for the period shown.

■ Non-performing loans and appropriated assets
◆ 1-year lag/1 year earlier
● 2-year lag



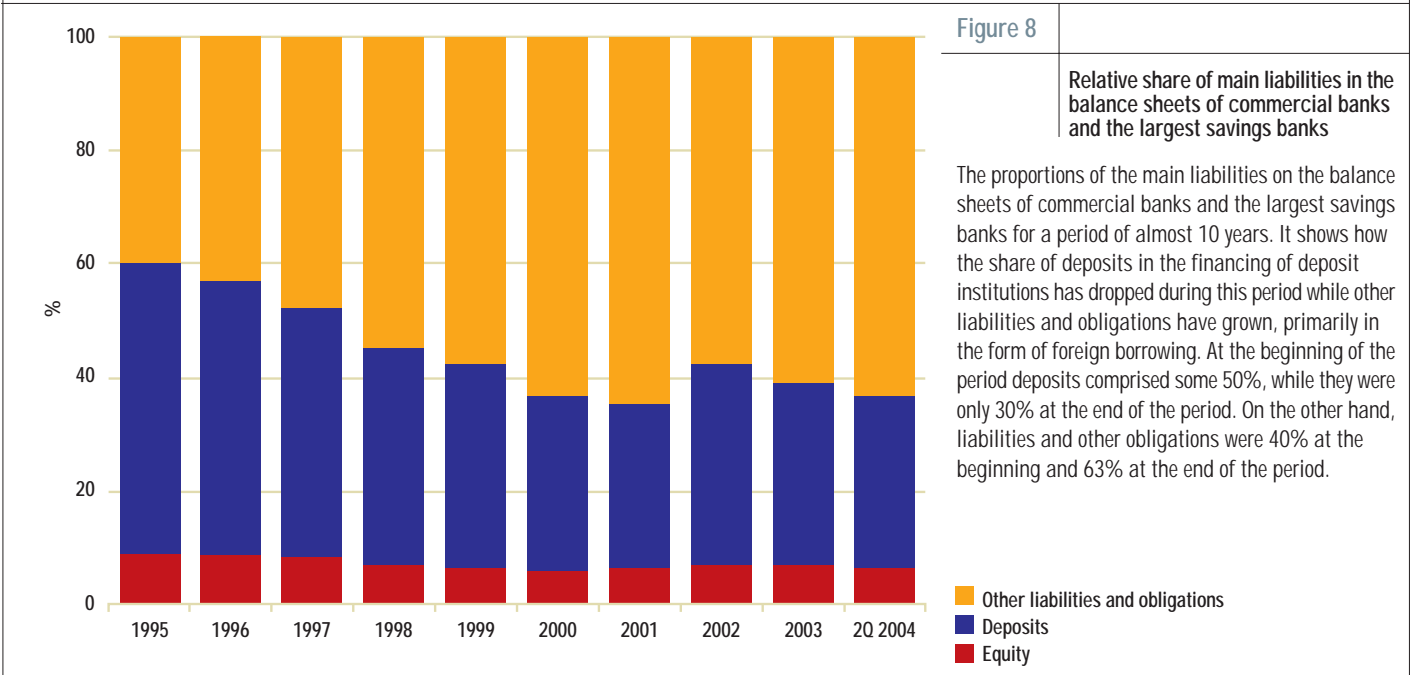
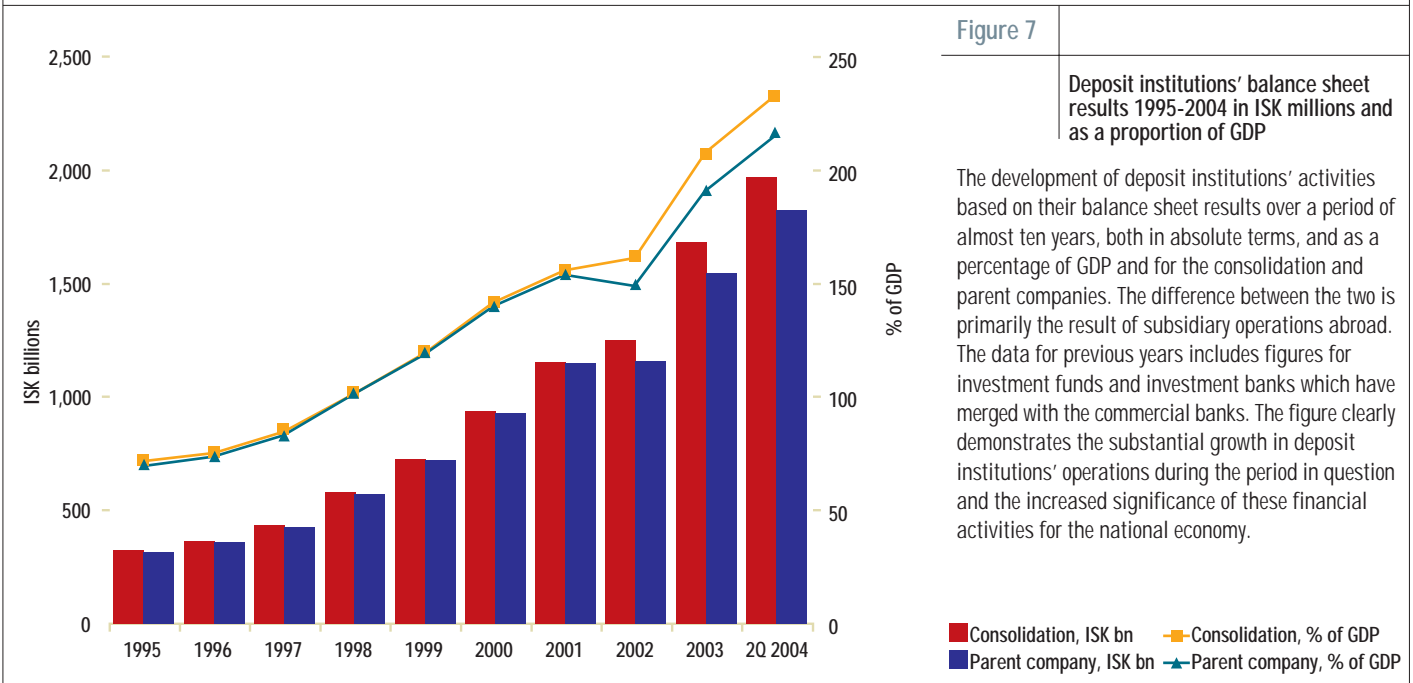
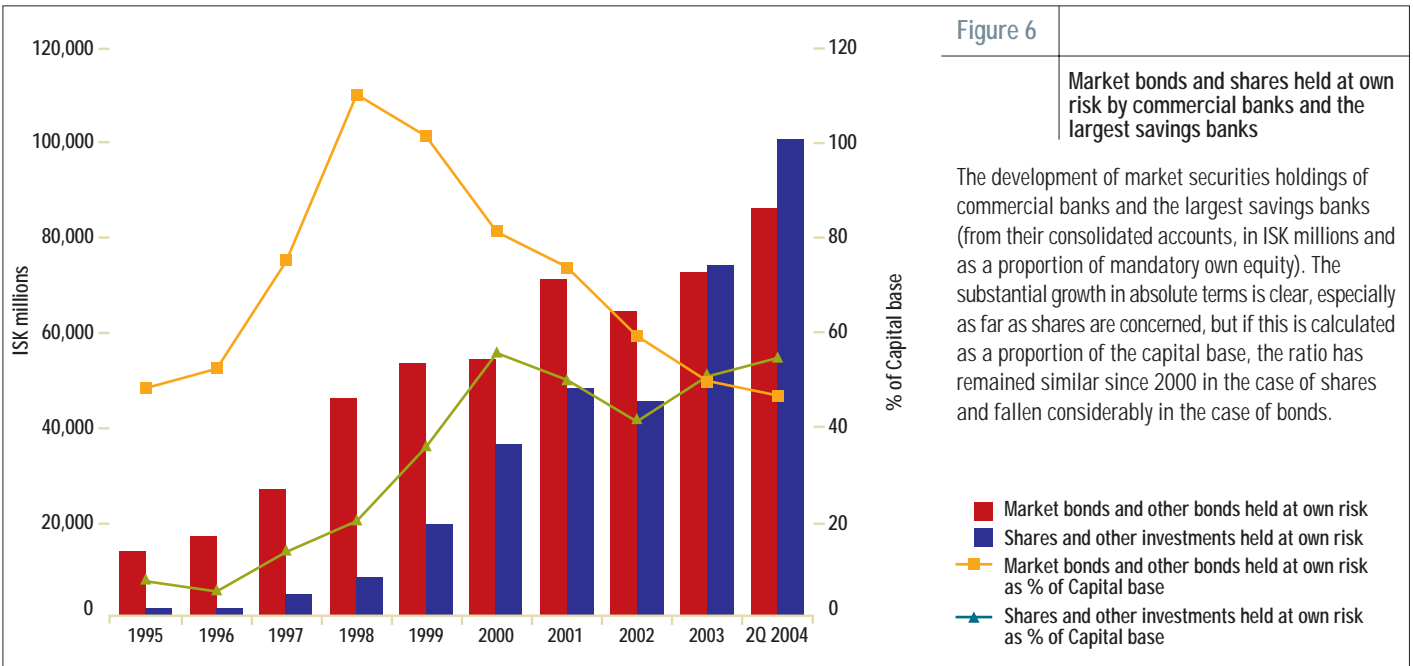


Figure 9

Gross and net liabilities of commercial banks and savings banks to foreign parties

How gross and net liabilities owed to foreign parties by commercial banks and savings banks have developed (parent company statements) from June 1998 to June 2004. Since the end of 2002 gross liabilities have doubled, while net liabilities have grown by 60%. The liabilities are practically exclusively connected with the three largest commercial banks.

■ Total liabilities
■ Net liabilities

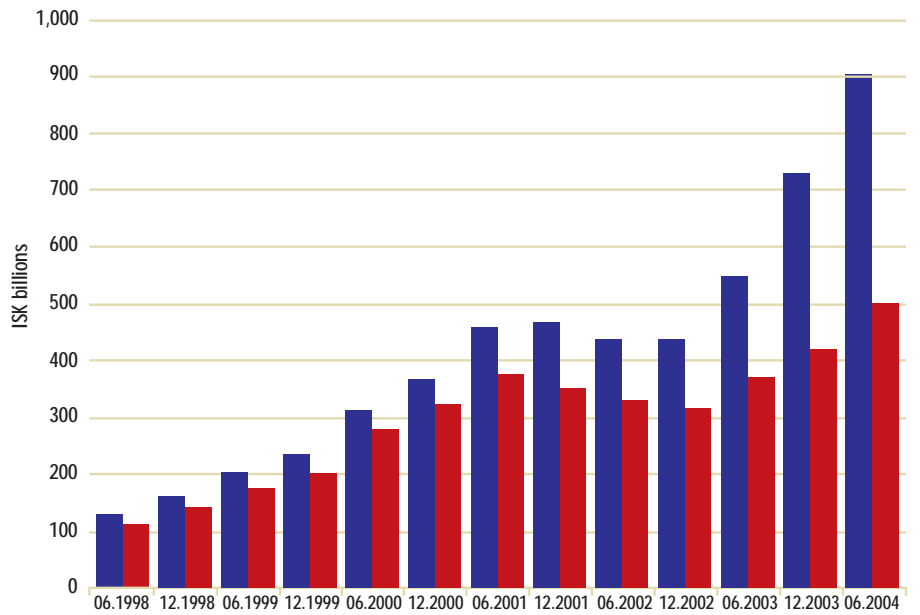


Figure 10

Book value of equity of deposit institutions 1995-2004 in ISK bn and as % of GDP

How the book value of deposit institutions' equity has developed over a period of almost 10 years in absolute terms and as a proportion of GDP. The development is similar to that of Figure 7, i.e. a substantial growth during the period concerned. At the beginning of the period the book value of deposit institutions' equity was ISK 30 bn and close to 7% of GDP, while the comparable figures at the end of the period are ISK 142 bn and close to 17%.

■ Equity
◆ Equity as % of GDP

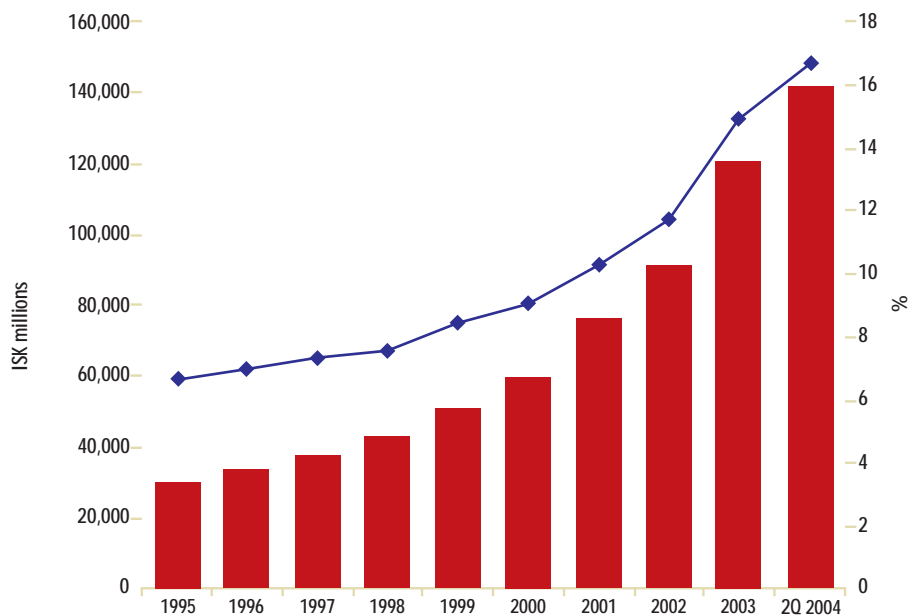
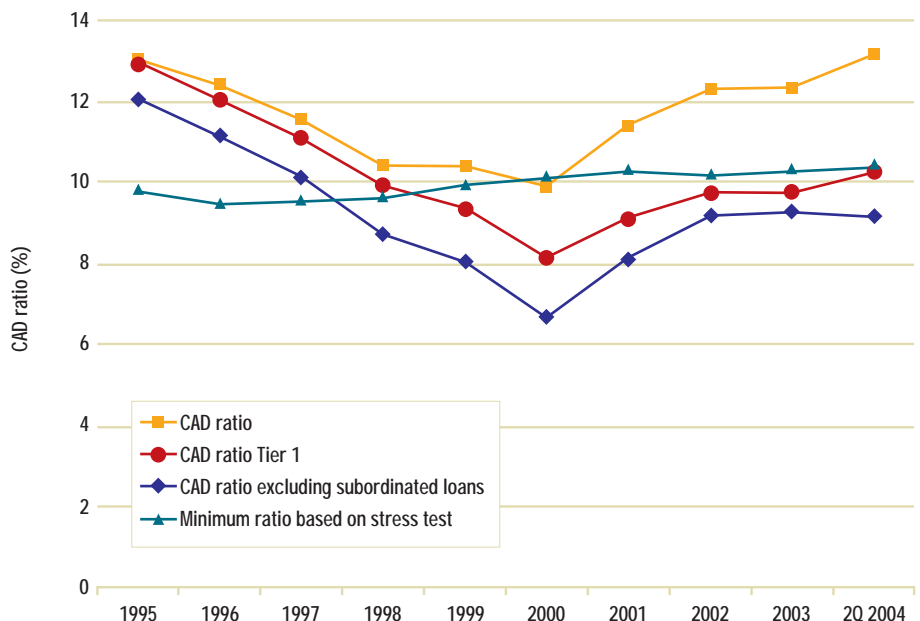


Figure 11

CAD ratio with and without subordinated loans (commercial banks and the largest savings bank)

How the CAD ratios for commercial banks and the largest savings banks have developed during a period of almost 10 years. It also shows the mandatory minimum CAD ratio, the ratio of Tier 1 capital, and the equity ratio excluding subordinated loans. Furthermore, it shows the minimum CAD ratio based on a stress test involving a decrease in the value of certain asset items: a 25% decrease in the book value of shares held at own risk, a 7% drop in the value of market bonds held at own risk and a 20% drop in the value of non-performing loans and appropriated assets. At the end of June 2004, the overall CAD ratio was 13.1%, the ratio of Tier 1 capital was 10.2% and the equity ratio excluding subordinated loans was 9.1%. The minimum ratio using a stress test was 10.3%.



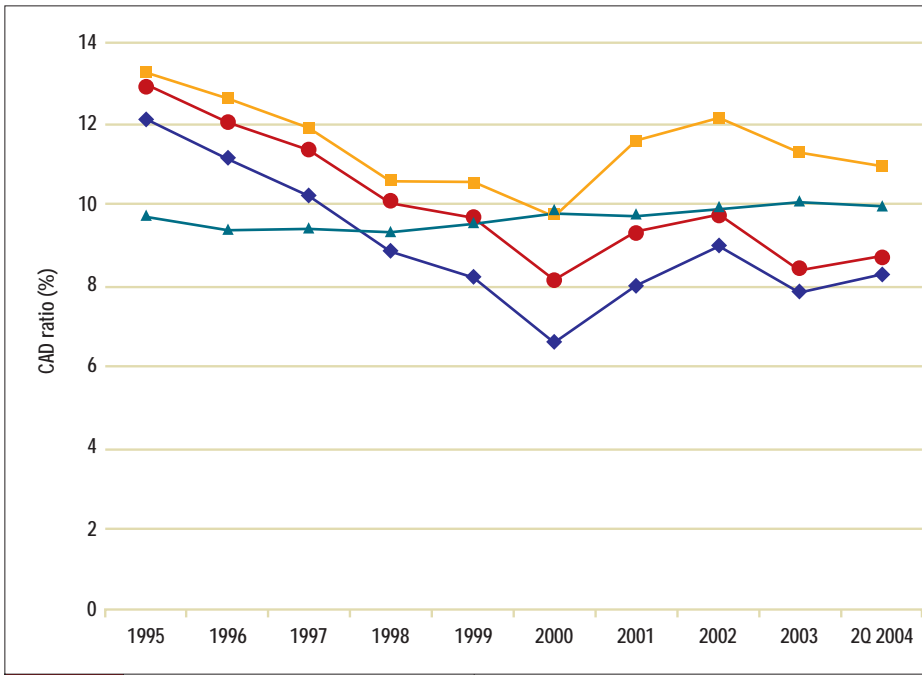


Figure 12
CAD ratio with and without subordinated loans for commercial banks and the largest savings banks, excluding Kaupthing Bank

The same development of CAD ratios as is shown in *Figure 11* but excluding Kaupthing Bank. Due to Kaupthing Bank's especially high equity situation recently and due to this bank's major weight in the calculation of total equity (a weighting of approx. 40%), it is necessary to also examine the situation of commercial banks and the largest savings banks excluding Kaupthing Bank. At the end of June 2004, the overall CAD ratio, excluding Kaupthing Bank, was 11.0%, the ratio of Tier 1 capital was 8.7% and the equity ratio excluding subordinated loans was 8.3%. The minimum ratio using a stress test was 9.9%.

■ CAD ratio
● Tier 1 capital
◆ CAD ratio excluding subordinated loans
▲ Minimum ratio based on stress test

2.2 The securities market

Favourable development of the securities market

Financial market developments in 2003 and during the year to date have continued to be favourable for investors. The ICEX Main List and ICEX-15 indices have never been higher and bond market returns have also been substantial. Total bond and share turnover in 2003 was ISK 1,578 bn, increasing 39% from the previous year.

Share trading amounted to ISK 554 bn in 2003 and has never been higher. The YoY increase over the previous year's record high was 72%. Share turnover velocity was 95% as compared to 65% the previous year. Total share trading during the first six months of 2004 amounted to ISK 285 bn, which is a record for the first half of any year. Much of this increase in turnover can, as in previous instances, be traced to mergers of companies and transfers of major holdings.

Turnover in the bond market in 2003 also set a record, amounting to ISK 1,024 bn, or a 26% YoY increase. Total bond turnover during the first six months of 2004 was ISK 715 bn, which is an increase of 36% over the first six months of 2003. This increase in turnover can be in part attributed to economic growth and expectations of interest rate hikes by the Central Bank.

Increase in market value and decrease in number of listed companies

The number of listed companies on the Iceland Stock Exchange (ICEX) has dropped steadily in recent years. In many instances the delisting

of companies has been the result of their merging with other listed companies. Despite the decrease in the number of listed companies, the market value of companies listed on the Exchange has grown substantially. This favourable trend on the equities market can be partly attributed to the successful operations of listed companies, not least those who have made inroads into markets abroad. While this development means fewer domestic investment options, the liquidity of shares in larger companies becomes greater. As a result of this development, Icelandic investors have increased their investments abroad, primarily in foreign funds.

The share price of several listed companies has risen by more than 100% since the beginning of the year, most of these in the financial sector. The investment company index and the index for the finance and insurance sector have therefore risen greatly during the year and these companies comprise a very significant share in the total market value of ICEX-listed companies. It could be pointed out that there are considerable cross-holdings among companies on the Icelandic securities market, not least in the financial sector. Because of these mutual holdings, it is clear that share price increases of individual companies have multiplier effects throughout the entire market. As a result of the mutual holdings, when the share price of company A increases, then so does the share price of company B due to its holding in A, and where A also has a holding in B, this has the effect of further raising A's share price. The impact of these internal connections is a major cause for concern, because they also apply when there is a market downturn. Another point which should be made is the frequent leveraged share

purchases, for instance, due to transfers of major holdings.

Market analysts have for some time now pointed out that the Icelandic share market is over-valued and have forecast a price correction. It is difficult to say when such a price correction will take place or the size. However, signs of such a correction can be found in the latter part of October.

The development which has occurred on the Icelandic securities market, i.e. the major price upswing until October this year, is highly noteworthy in comparison with the trend on most foreign markets, where quite the opposite has occurred, i.e. a very slow upward movement or even downturn. This growth cannot be explained merely by the decrease in the number of investment options, or the current activities of the companies. A major factor would appear to be Icelandic investors' confidence in the expansion by Icelandic companies into markets abroad, as well as the transfer of major holdings and the impact of mutual ownership, as previously mentioned.

Times have changed on the bond market

In 2004, The Housing Financing Fund (HFF) offered investors to switch specified classes of Housing Bonds (IBH) and Housing Authority Bonds (IBN) for new HFF Bonds. These new bonds can be settled with international clearing houses, a new option for investors. HFF held two closed auctions during the year, directed exclusively at foreign investors, and foreign investment in Icelandic bonds has increased, in part as a result of this.

In the late summer and autumn months of 2004, financial undertakings began directly competing with HFF by offering housing mortgages on better terms than had previously been available. The impact of this competition on the mortgage market is not fully evident as yet, but it is clear that many individuals have taken advantage of this opportunity to purchase larger properties than they would otherwise have done and to consider refinancing their loans. It is therefore conceivable that the net supply of long-term indexed, government-backed bonds may decrease. Eventually, however, the banks can be expected to finance their indexed mortgages by issuing long-term bonds.

Information disclosure to supervisory authorities

When the inadequacy of information disclosure by companies listed on ICEX has been pointed out, the traditional reply has been that the Icelandic financial market has only recently begun to develop and is still in its infancy. Such an excuse can hardly be acceptable indefinitely. Today there is no reason for not making realistic and normal demands of these companies concerning information disclosure. The companies have had sufficient time to acquaint themselves with the demands made of them in this respect and to adapt to them. The new position of

compliance officer should have become part of the normal order of business and both company management and primary insiders should be well aware of their obligations. Unfortunately, there are still major inadequacies with regard to the above-mentioned information disclosure to supervisory authorities by listed companies. More determined action will be carried out by the supervisory authorities in response to infringements against rules on disclosure requirements.

Figure 13

ICEX Main List and ICEX-15 indices

The ICEX Main List index rose by 44% YoY in 2003. It rose above the 3000 level on 12 August this year and has increased by almost 72% during the first nine months of 2004. The highest closing level for the index during the first nine months of this year was on 30 September, when it closed at 3565.41. The development of the ICEX-15 index has been similar, as it rose by over 56% YoY in 2003, plus close to an additional 80% during the first nine months of this year. The ICEX-15 index topped the 3000 level on 12 July 2004, and closed at 3802.37 on 30 September, its highest closing point during the first three quarters of the year.

— ICEX-15
— ICEX Main List

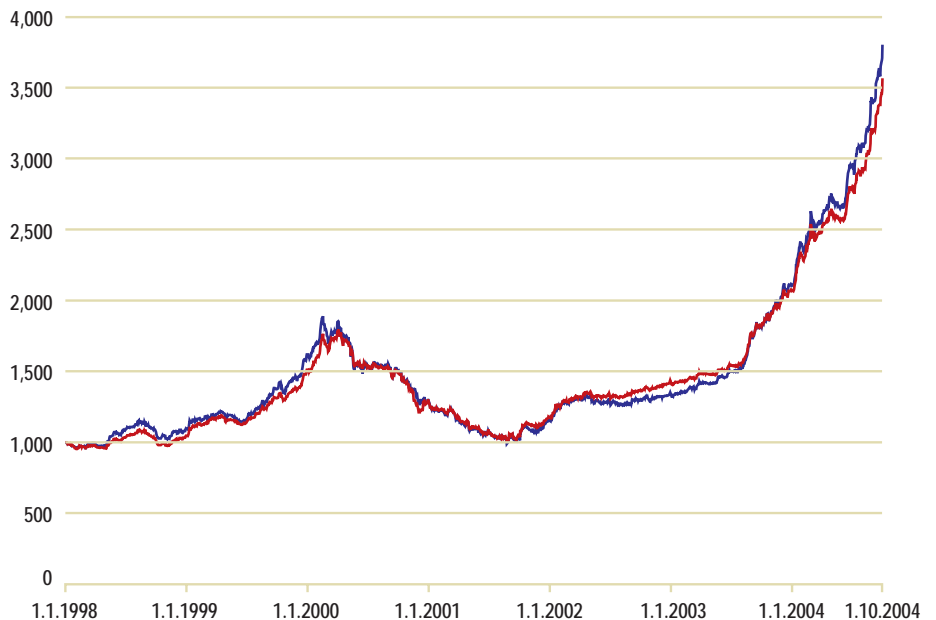


Figure 14

Number of ICEX-listed companies at the end of each period

Listed companies on ICEX have decreased steadily in number since the year 2000, when a total of 75 companies were listed on the exchange. The greatest drop in the number of listed companies occurred in 2003, when they fell from 64 to 48. As of 30 September 2004, 40 companies were listed on ICEX, a drop of 8 since the beginning of the year. The trend has not yet concluded, since the delisting of three additional companies is pending after take-over obligations have arisen. No new company was listed during the first nine months of this year.

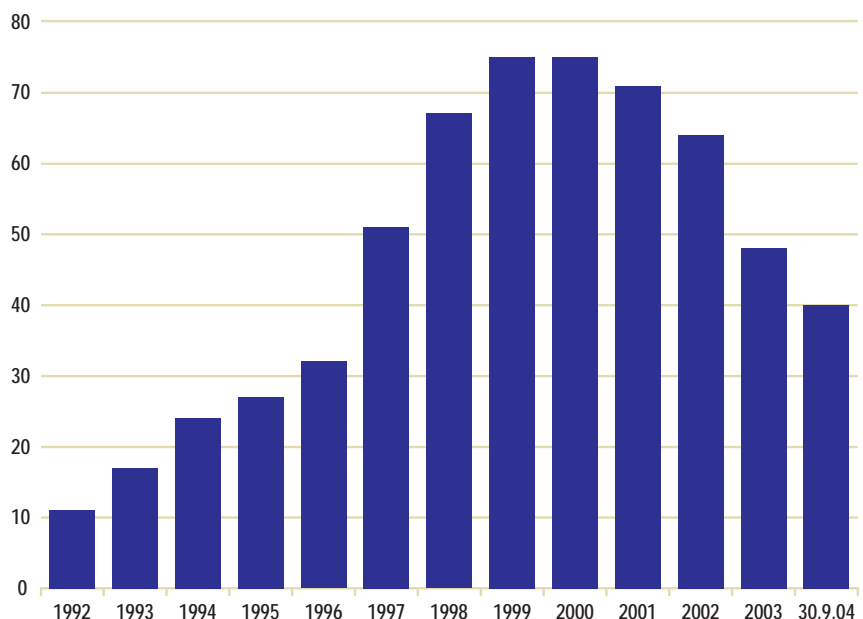
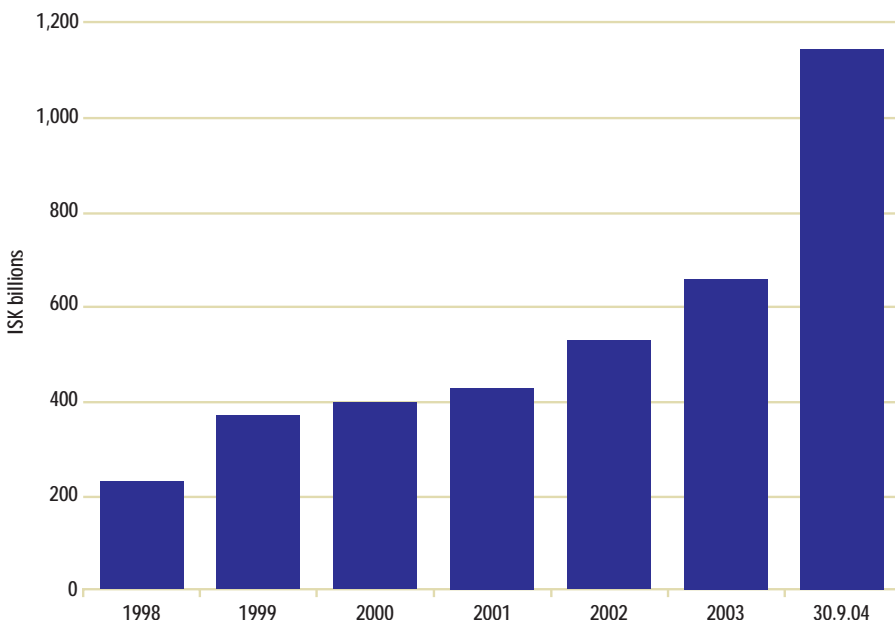


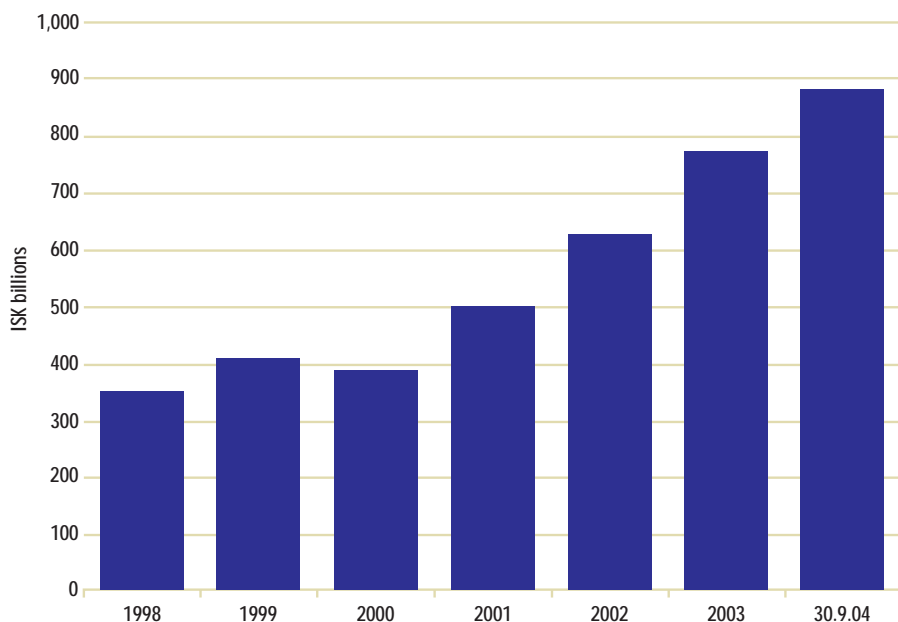
Figure 15



Market value of listed shares – ISK millions

A steady rise was in the market value of listed companies on ICEX to the end of September 2004. The YoY increase amounted to 24% in 2002, with total market value growing from ISK 428 bn to ISK 529 bn. The increase the following year was close to 25%, with market value of ICEX-listed companies amounting to ISK 659 bn at year-end 2003. To the end of September 2004 the market value of listed companies has increased just over 73% when totalling ISK 1,142 bn.

Figure 16



Market value of listed bonds and bills

A steady growth in the market value of bonds and bills has occurred since the year 2000. The increase was greatest from 2000 to 2001, rising from ISK 390 bn to ISK 501 bn, or by just over 28%. During the first six months of this year, the market value of listed bonds and bills rose from ISK 773 bn to ISK 828 bn, or by 7.2%. During the first three quarters of this year, the market value of listed bonds and bills has risen by ISK 881 bn, or over 14%.

2.3

The pension savings market

Pension funds

In 2003 the profitability of pension funds was high, with the real rate of return 11.3% following negative returns in the preceding three years. All pension funds except one, showed positive returns in 2003. Then it is clear that the rate of return during the first half of 2004 was also high. Pension funds net assets at year-end 2003 amounted to ISK 824 bn and amounted to 104% of GDP. The funds' good results in 2003 meant an improvement to their actuarial status and all pension funds were in actuarial balance, as defined in the Pension Funds Act. Despite their improving situation, the funds are unlikely to increase members' rights in the near term, since it is necessary to take a long-term perspective, and consider both rising life expectancy as well as the increasing incidence of disability. The actuarial status of pension funds not guaranteed by an employer is poor and now as before, gives cause to examine these funds' financial situation and make the necessary improvements.

During the latter part of 2004, several pension funds lowered their lending rates on mortgages to individuals, following the lowering of mortgage rates by the Housing Financing Fund (HFF) and banks. This reflects the dropping real interest rate level in Iceland, but pension funds have through the years based their investments to a considerable extent on the

relatively high inflation-indexed interest rates on offer in Iceland. Actuarial assessments of the funds assume a long-term, net real rate of return of 3.5% in discounting future premiums, expected pension benefits and the funds' fixed-income securities. If the real interest rate level in Iceland should drop permanently below that benchmark, the premises for the above real rate of return will need to be examined. Real interest rates, however, are still above 3.5%, in addition to which the funds' investments are much less homogenous than previously. Pension funds currently invest, for instance, to an increasing extent in shares and on foreign markets, which should enable them to obtain improved risk diversification and good returns in the longer term.

As of 1 July 2004, there were 49 pension funds in operation. Of these, 38 are still fully operational, while 11 no longer receive contributions. Fourteen of the 49 pension funds are guaranteed by another party, i.e. the state, a local authority or banks. Several of the funds operate more than one financially separate division with varying rules on collecting rights. As of 1 July 2004, there were 58 mutual insurance divisions and 38 private pension schemes, or a total of 96 financially separate divisions operated by pension funds. There were 66 pension funds at the end of 1998. Their numbers have dropped on average by three each year during the period from 1998 to 2003.

Pension fund contributions increased slightly during the year, from ISK 67 bn in 2002 to ISK 73.6 bn during 2003. Pension payments amounted to ISK 28.7 bn in 2003, as compared to ISK 22.2 bn in 2002.

Supplementary pension cover and personal pension savings

The entry into force of Act No. 129/1997 in mid-1998 authorised pension funds, commercial banks, savings banks, securities firms and life insurance companies to accept premiums for pension savings and supplementary insurance cover in addition to the mandatory minimum coverage.

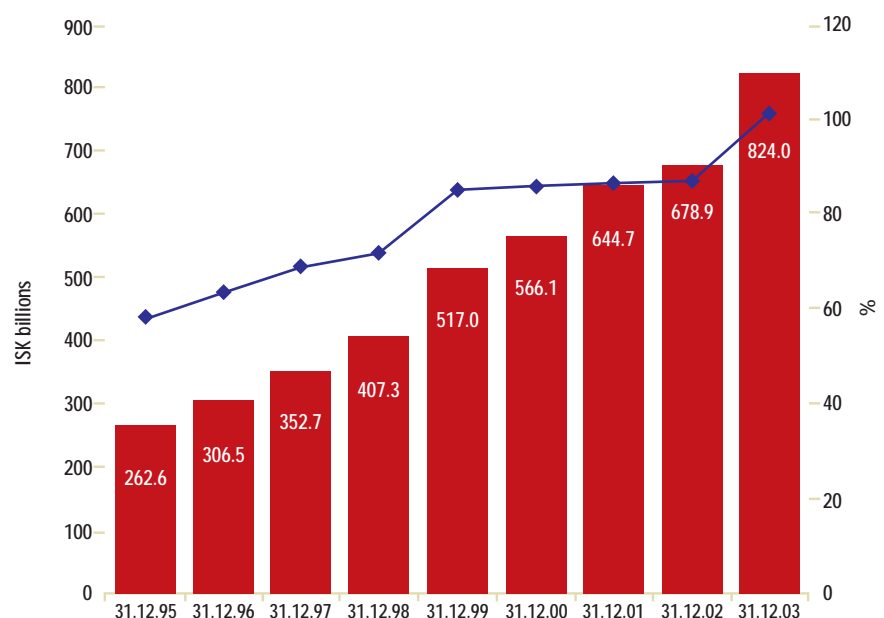
At year-end 2003, there were 50 parties offering pension savings schemes and supplementary insurance cover: 20 pension funds, 3 commercial banks, 23 savings banks, 1 securities firm and 3 life insurance companies.

At the end of 2003, the accumulated pension savings in the custody of parties other than pension funds amounted to ISK 16.2 bn while the net assets of the pension funds amounted to ISK 824 bn. Total personal pension funds for both minimum and supplementary insurance cover thus amounted to ISK 840.2 bn at year-end 2003.

Figure 17

Net assets of pension funds

The net assets of pension funds for payment of pensions at year-end amounted to ISK 824 bn, as compared with ISK 678.9 bn at year-end 2002. The increase of 21.4% represents a real increase of 18.2% when adjusted using the CPI. At year-end 2003, the net assets of pension funds were equivalent to 104% of GDP, as compared to 87.1% at year-end 2002.



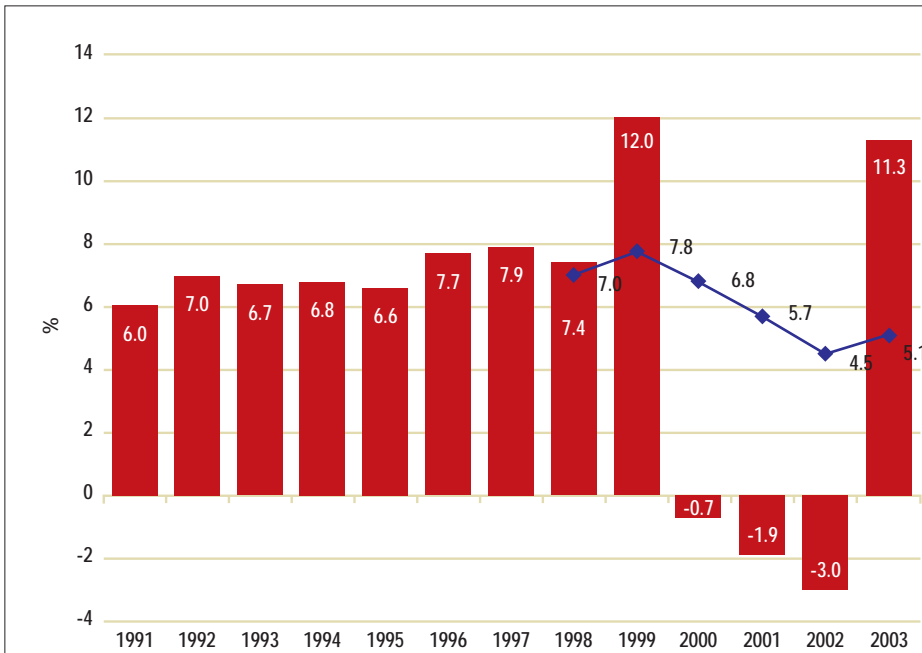


Figure 18
Pension funds' real net rate of return

The net real rate of return of pension funds after adjusting for inflation was 11.3% in 2003. At year-end 2003, the five-year average was 3.5% and the average for the last ten years 5.4%. Pension funds' real net rate of return is their rate of return adjusted for inflation using the CPI after deducting costs from their investment income. As pension funds are long-term investors, it is natural to examine their rate of return over a period of several years in assessing how successful they are.

■ Net annual rate of return
◆ Eight years average of real net rate of return.

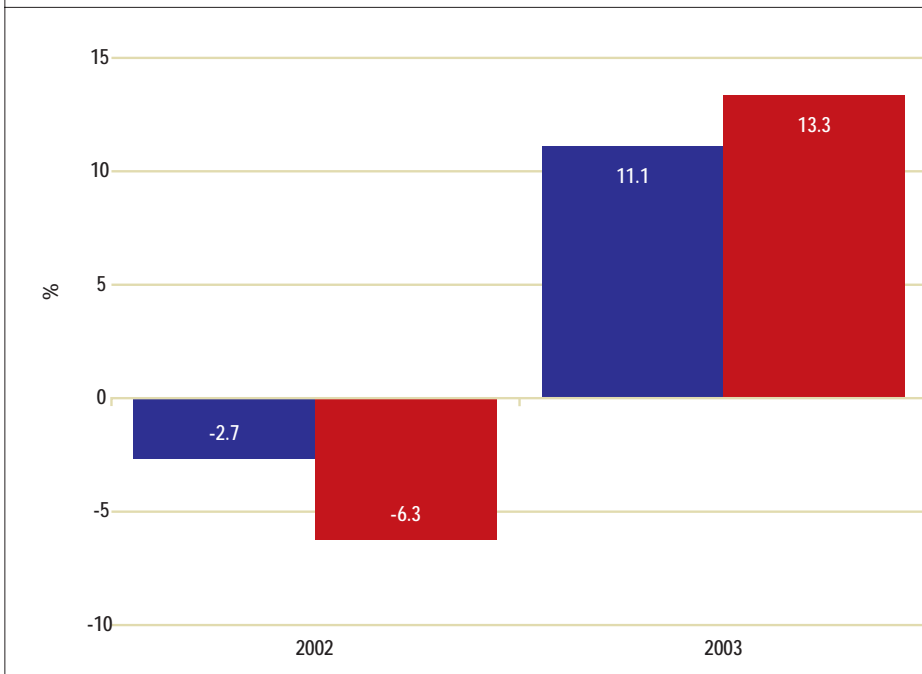


Figure 19
Rate of return on mutual insurance divisions and private pension schemes in the year 2002 and 2003

The different rates of return for mutual insurance divisions and private pension schemes and underlines the necessity of taking investment policies into consideration when comparing the rates of return for individual funds or divisions. The investment policies of private pension schemes generally involve higher risk than those of mutual insurance divisions due to the different nature of the savings, and this is reflected in greater fluctuations in the rate of return.

■ Mutual insurance divisions
■ Private pension schemes

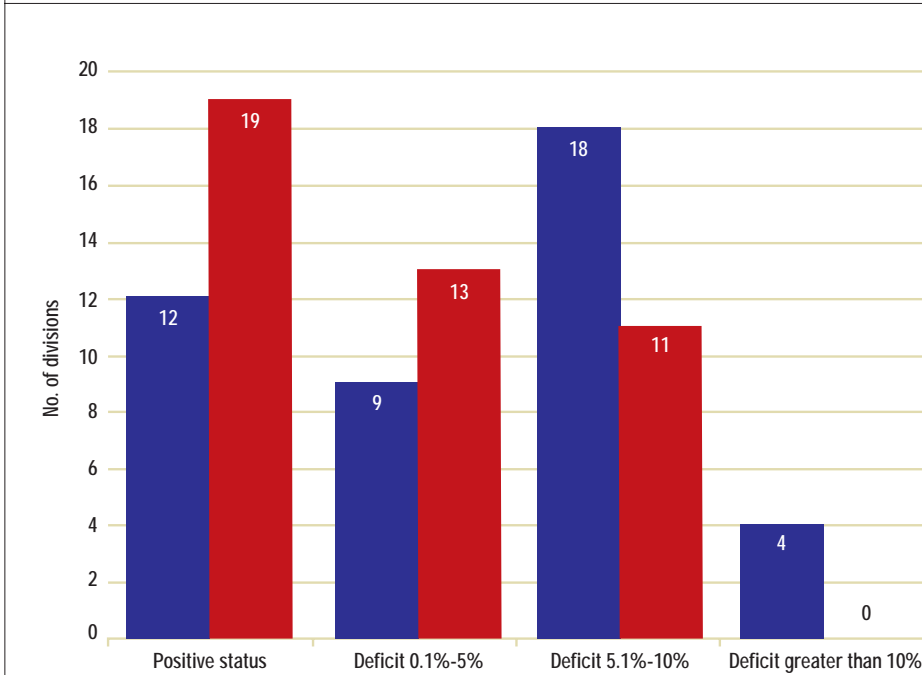


Figure 20
Actuarial status of pension funds not guaranteed by other parties

The actuarial status of pension funds not guaranteed by an employer has substantially improved during 2003. At year-end 2003, there were 34 such funds, operating 43 divisions. Nineteen of these divisions had a positive balance while 24 showed deficits ranging from 0.1 to 10%. The status of individual divisions ranged from -8.6% to 8.7%. According to the Pension Fund Act, if the difference between a fund's assets and obligations amounts to more than 10% in an annual actuarial assessment, the fund's statutes must be amended in order for it to achieve a balance. The same applies if a difference between 5 and 10% lasts for a continuous five-year period.

■ Year-end 2002 ■ Year-end 2003

Figure 21

Actuarial status of pension funds guaranteed by other parties

The financial status of pension funds guaranteed by other parties is practically unchanged from one year to the next. Most of the divisions included here show a substantial deficit. These divisions are exempt from the provisions of the Pension Funds Act on full funding by contributions; the employer makes up the deficit so that the funds' assets will be sufficient to meet its obligations. These divisions do not accept new members. Of the 16 divisions of 14 pension funds guaranteed by other parties, one division had a deficit of between 0-50%, 14 had deficits ranging from 51-100% and one division was in balance. The deficits of individual divisions ranged from 5.1-96.8%.

■ Year-end 2003
■ Year-end 2002

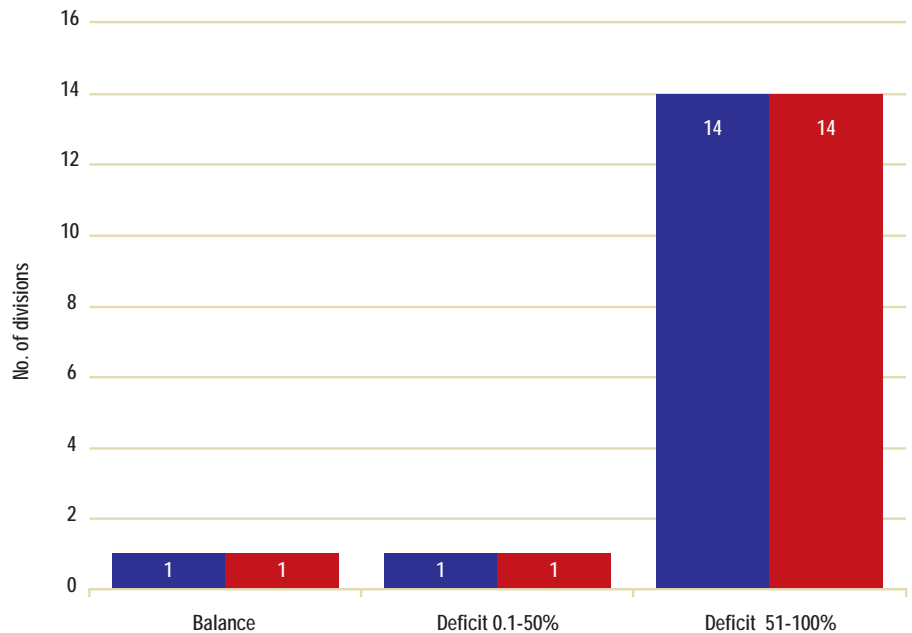


Figure 22

Breakdown of pension funds' assets at year-end 1997 and 2003

The composition of pension funds' assets has changed markedly in recent years. This comparison between 1997 and 2003 indicates that variable-yield securities now comprise a larger share of the funds' assets than previously. During this period, the share of variable-yield securities has grown from 15% to 40% of the funds' net assets, with a corresponding drop in fixed-income securities. Variable-yield securities include equities and unit share certificates in UCITS, although UCITS may be comprised exclusively of fixed-income securities.

■ Variable-yield securities ■ Mortgages
■ Fixed-income securities ■ Other assets

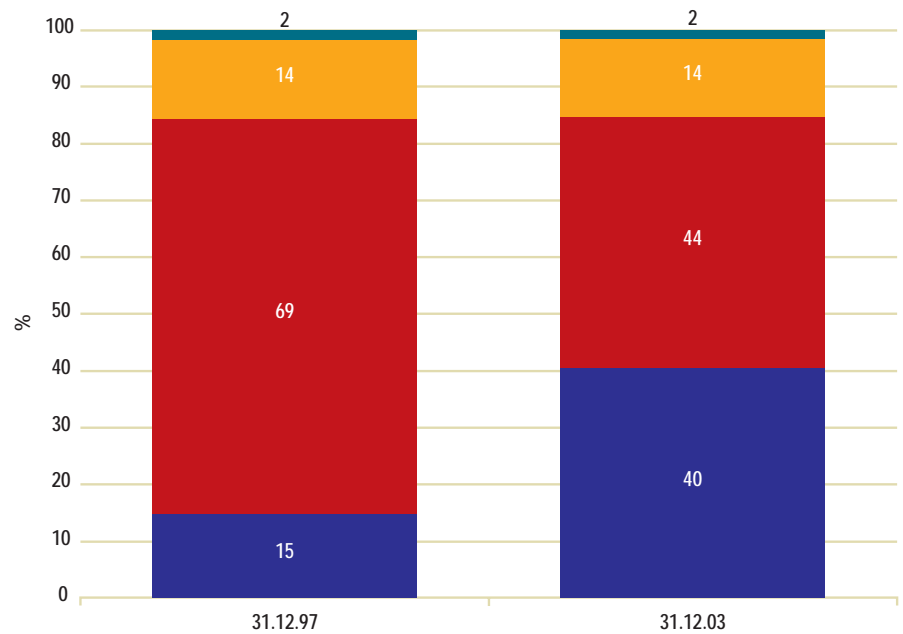
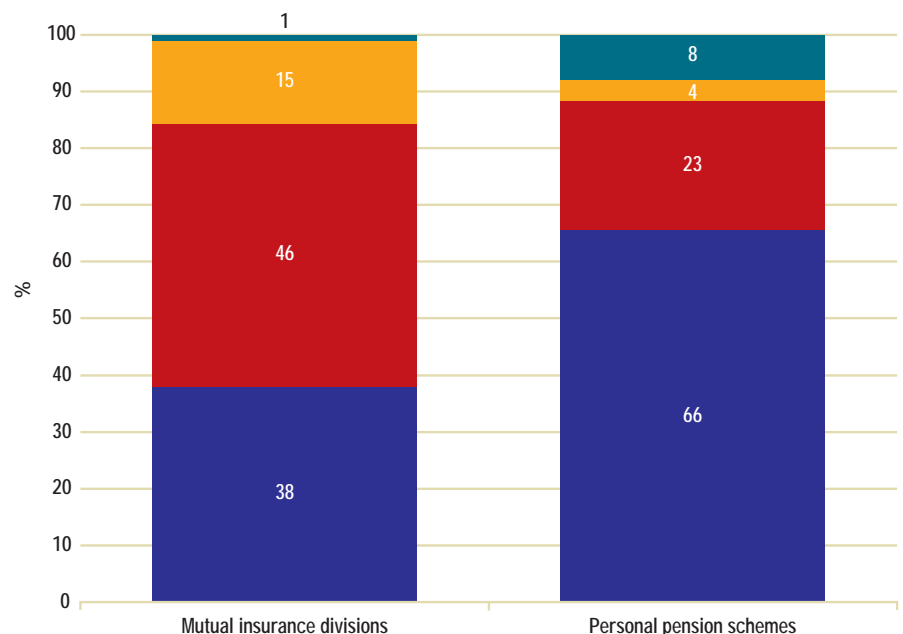


Figure 23

Breakdown of assets at year-end 2003

Breakdown of the assets of mutual insurance and private pension divisions. As is evident from this figure, the divisions follow different investment policies. It should be borne in mind that around 80% of the assets of the personal pension divisions were originally pension funds operating as purely private pension schemes prior to the entry into force of the Pension Funds Act. They are operated by the commercial banks, who manage their assets to a considerable extent through their mutual funds.

■ Variable-yield securities
■ Fixed-income securities
■ Mortgages
■ Other assets



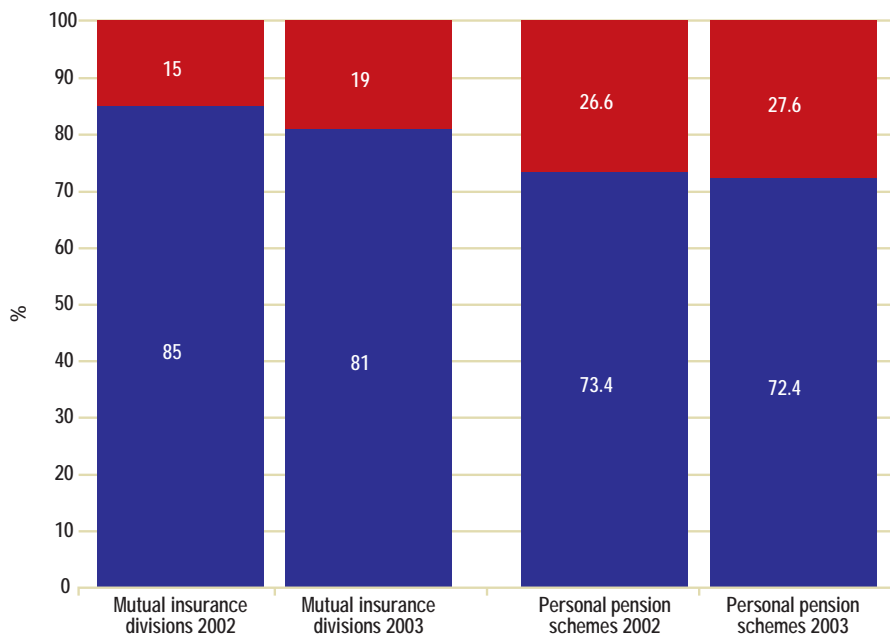


Figure 24

Exchange-rate-linked assets at year-end 2002 and 2003 as a percentage of net assets

At year-end 2003, pension funds' exchange-rate-linked assets amounted to around 20% of their net assets, as compared with 16% at year-end 2002, a rise of around 4%. Pension funds are authorised under the Pension Funds Act to hold up to 50% of the value of their net assets for payment of pensions in exchange rate linked assets. Exchange-rate-linked assets can be expected to continue to grow in coming years.

■ ISK assets
■ Assets in other currencies

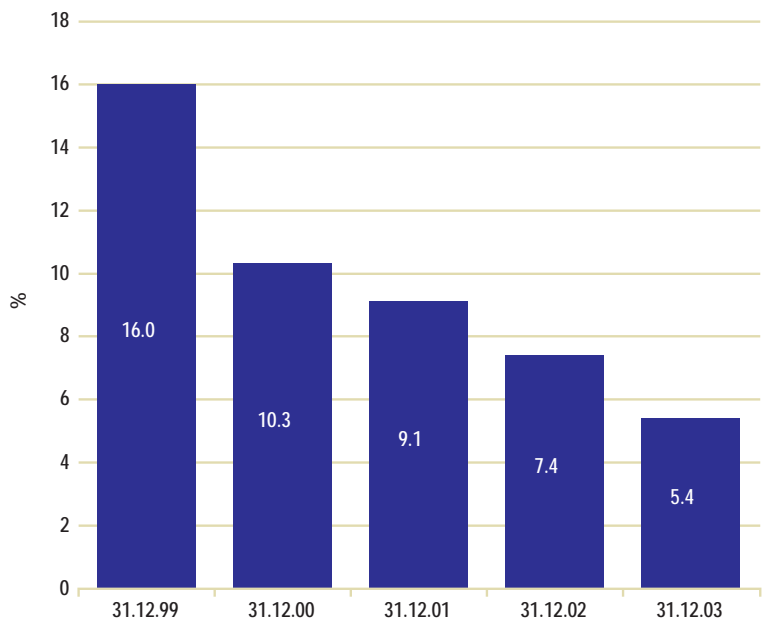


Figure 25

Unlisted securities as a percentage of net assets

The share of unlisted securities in pension funds' net assets dropped by around 2% in 2003, decreasing from 7.4% at year-end 2002 (ISK 51.2 bn) to 5.4% (ISK 44.7 bn) at year-end 2003. According to the Pension Funds Act, unlisted securities may comprise a maximum of 10% of a fund's net assets for payment of pensions. Since the entry into force of the Act, the funds have been reducing this proportion to comply with the limit; at year-end 1999 this proportion was 16%. Although the overall share of unlisted securities is now less than 10%, there are still 10 funds, which exceed this limit. At year-end 2003, 93% of the funds' unlisted securities were unlisted bonds, while 7% were unlisted shares.

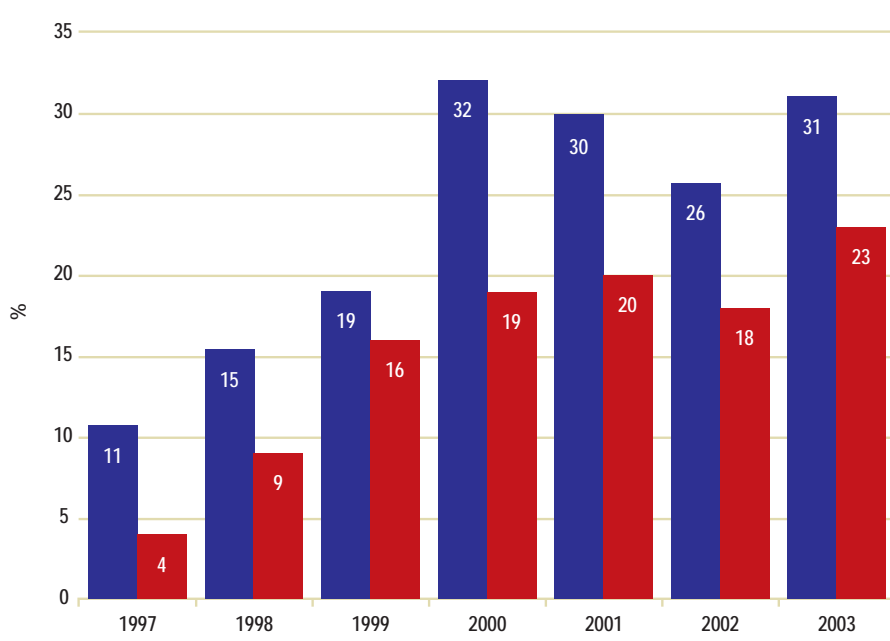


Figure 26

Percentage of shares and unit share certificates in pension funds' net assets at year-end

Variable-yield securities include shares in limited-liability companies and closed-end mutual funds, as well as unit share certificates in UCITS (open-end). At year-end 2003, the proportion of shares in pension funds' net assets was 31% (ISK 256 bn), increasing by five percentage points during the year. Since 1997 this proportion has increased from 11% to 31%. The Pension Funds Act provides for a maximum of 50% equities in total assets. At year-end 2003 the proportion of unit shares of UCITS in pension funds' net assets was 23% (ISK 187 bn) as compared to 18% at year-end 2002. In 1999 this was 4%. Unit share certificates are classified according to their underlying assets pursuant to the Pension Funds Act, which sets no maximum on their proportion in the funds' net assets. In accordance with the above, part of the funds' shareholdings are also shown under the columns for unit share certificates in the figure.

■ Shares ■ Unit share certificates

Figure 27

Personal pension savings by depository

At year-end 2003, total personal pension savings amounted to ISK 83.1 bn. The major share of these savings, 69.2% (ISK 57.5 bn) was on deposit with pension funds, which operated purely as personal pension savings funds prior to the entry into force of Act No. 129/1997. These personal pension savings are otherwise the result of supplementary contributions in excess of the 10% minimum mandatory contribution for minimum pension cover. The older personal pension funds do, however, offer minimum insurance cover through the integration of personal and mutual pension savings. Part of the 10% minimum contribution to the funds goes towards personal savings, which belongs to minimum cover, on the one hand, and supplementary cover on the other. Around ISK 6.5 bn of savings on deposit with these parties is intended for minimum insurance cover, or 7.8% of total personal pension savings.

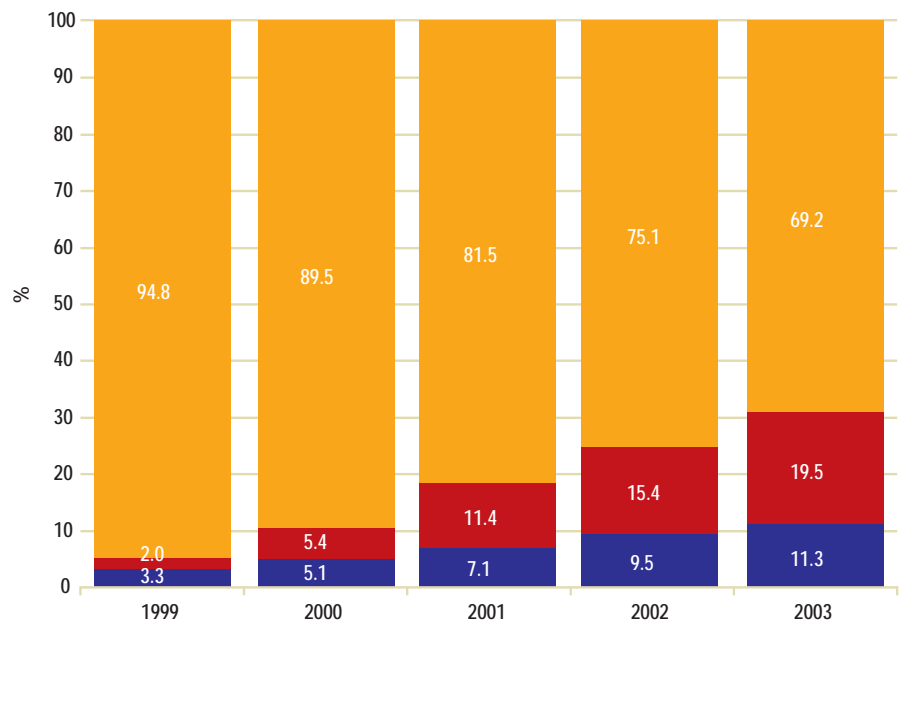
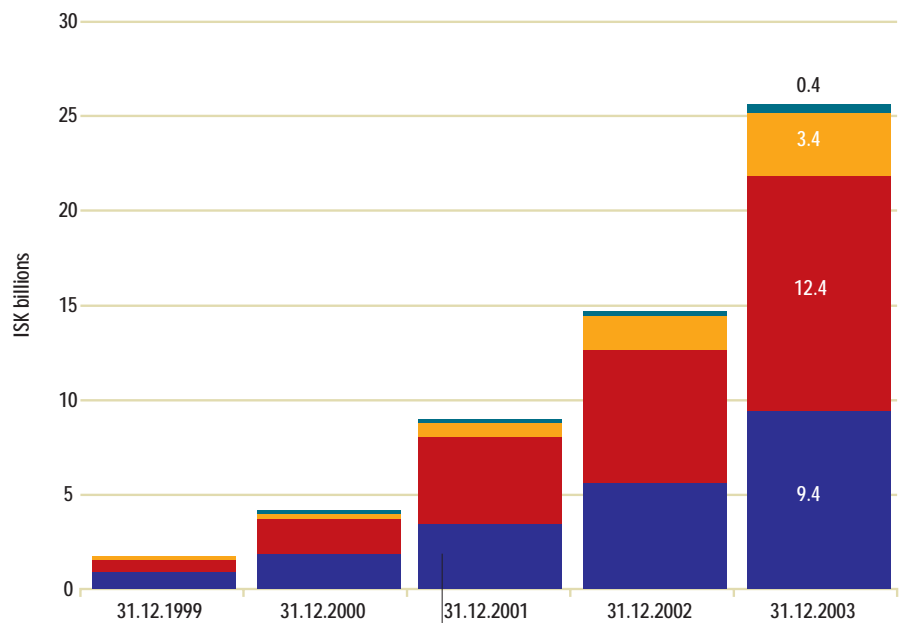


Figure 28

Cumulative personal pension savings on deposit with parties other than pension funds operating as purely private pension funds prior to the entry into force of Act No. 129/1997

Personal pension savings on deposit with funds other than pension funds operating purely as personal pension funds prior to the entry into force of Act No. 129/1997 amounted to ISK 25.6 bn at year-end 2003, as illustrated in Figure 28. These funds should preferably be excluded when examining developments since the entry into force of the Act. In 2003 the accumulated savings on deposit with the before mentioned parties grew from ISK 14.7 bn (at year-end 2002) or by 75%.



2.4 The Insurance Market

Insurance companies collect high returns on investments¹

Operations of insurance companies in 2003 are characterised primarily by very high revenues from financial activities. Their total financial income amounted to over ISK 5 bn. Non-life insurance operations also were very successful, returning a profit of ISK 3.6 bn to the insurance companies. The high investment income is in particular attributable to sales of shareholdings, which were substantial during the year. This resulted in considerable realised profits for the

¹ Iceland's natural catastrophe insurance (Viðlagatrygging Islands) is omitted in the following figures except in instances where its inclusion has negligible effect.

insurance companies, most of which enter securities at purchase price on their balance sheets.

There have been considerable changes in the asset composition of insurance companies in recent years. The companies have to an increasing extent become core investors in limited-liability companies, thus increasing the number of their subsidiaries and affiliates and their holdings in them. The companies assets in fixed-income securities and mortgages continue to drop. It is interesting to note that the share of reinsurers in technical provisions has dropped; see further the discussion below on developments in reinsurance coverage.

Reinsurers' share in insurance companies' claims drops

The difference between total premiums and claims is an indication of the operating conditions for insurance companies. Their situation has improved in this respect since 2001.

Reinsurance coverage is one of the factors, which affects the activities of insurance companies. Ever since 11 September 2001, premiums have generally been high on the reinsurance market. Icelandic insurance companies have to some extent been forced to re-examine their reinsurance agreements as a result.

<p><i>Figure 32</i> gives an overview of developments in premiums paid to reinsurers and their portion of claims paid during the period 1999-2003. In certain years major catastrophes have occurred, resulting in higher claims payments by reinsurers. This would appear to also have had an effect on the terms of reinsurance contracts concluded by Icelandic insurance companies.</p> <p>During the years preceding the terrorist attacks in the US in 2001, reinsurance terms had been fairly favourable, as is evident from the decreasing share of premiums paid to reinsurers 1999-2001. Since 2001, the portion of premiums paid to reinsurers has scarcely changed, although the share of claims covered by reinsurers dropped substantially last year.</p> <p>Between the years 2002 and 2003, the insurance companies' net retained risk increased in several reinsurance contracts. This change partly explains the decrease in share of claims covered by reinsurers. It could also be pointed out that a major portion of reinsurance agreements consists of excess of loss coverage, under which reinsurers cover claims in excess of specified limits. This makes it natural for the reinsurers' portion of claims to drop substantially when claims amounts decrease, as was the case last year.</p>	<p>competition has resulted in a decrease in premiums, so that the possibility of reducing premiums previously mentioned would appear to have been effected to some extent. FME has emphasised the need for transparent and internally consistent premium tariffs and bonus schemes, in order for consumers in general to benefit from the increased competition.</p>	<p>Strong growth in the life insurance market</p> <p>The small size of the life insurance market has been characteristic of the Icelandic insurance market. Last year the total assets of life insurance companies were just over ISK 7 bn, or equivalent to around 1% of GDP. This is a much lower percentage than the norm in neighbouring countries. In comparison, it could be pointed out that assets of life insurance companies in Denmark correspond to around half of the country's GDP. The life insurance companies were for a long time even smaller than today, as they have grown in recent years.</p> <p>In 1996, non-life insurance companies were 19 times larger than life insurance companies, measured in terms of their balance sheet assets. In 2003 they were 10 times as large. The growth in life insurance companies' total assets during this period has been great and considerably greater than the growth of non-life insurance companies, although the latter have also expanded. In addition, insurance brokers have also sold numerous policies with foreign life insurance companies. It should be borne in mind that this past year a new life insurance company began operations, and it is clear that the relative weight of the life insurance market is growing steadily in Iceland.</p>
<p>Profits increase in mandatory motor vehicle insurance</p> <p>After losses in this sector for several years previously, mandatory motor vehicle insurance has returned a profit to the insurance companies since 2001. This profit increased by 118% last year. The amount of claims, however, dropped by only 3%, so that the increased profit can be attributed primarily to increased investment income.</p> <p>Last June, FME issued a news announcement concerning its examination of the basis for premiums and provision for claims in mandatory motor vehicle insurance. In the estimation of FME, there appeared to be indications that premiums could be reduced, if the trend in recent years continued.</p> <p>There have been some changes to the competitive environment of mandatory motor vehicle insurance in recent years. In the past five years, the three largest insurance companies, Sjóvá-Almennar tryggingar hf., TM Insurance Ltd. and the Insurance Company of Iceland Ltd., have controlled a 97.5% market share in motor vehicle insurance. This share increased significantly in 2001, after brokering of motor vehicle insurance offered by a foreign company ceased. Since that time new parties have entered the market and in 2003 the situation had become similar to what it was in 2000. The increased</p>	<p>Little improvement in property insurance despite premium increases</p> <p>As mentioned in FME's 2003 report, premiums in several classes of property insurance increased at the end of 2002. We can assume that the increases were only partly visible in last year's premiums. This past year, however, premiums increased while total claims decreased. This past year's profit cannot be considered very great, however, in view of the large deficit in property insurance in the preceding two years.</p> <p>As <i>Figure 36</i> shows, due to the lower technical provisions, property insurance does not provide the same investment income as, for example, motor vehicle insurance. The loss ratio in property insurance thus has to be lower in order for the sector to be profitable. All the premium increases should have come into effect during the current accounting year, but the statements issued so far for 2004 do not indicate that profit in this sector has increased.</p>	<p>Strong solvency position of non-life insurance companies</p> <p>Act No. 37/2003 amended Articles 29-33 of Act No. 60/1994, on insurance activities concerning solvency and minimum solvency requirements. The changes come into effect at the end of this year. This will mean some changes in what is included in solvency, but the main changes will be to calculation of minimum solvency as provided for in Articles 30 and 31 and the minimum solvency amount provided for in Article 33.</p> <p>As indicated in <i>Figure 39</i>, the insurance companies' solvency position under the previous rules on minimum solvency was fairly strong at the end of 2003, especially for non-life insurance companies. While the changes in calculation of minimum solvency can be expected to increase this somewhat, the insurance companies appear to have room to accommodate this.</p> <p><i>Figure 39</i> also shows the minimum amount provided for in Article 33, following the amendments; insurance companies holding operating licences at year-end 2002 have until 2007 to fulfil the minimum requirements. As is evident from the figure, in a few instances life insurance companies will need to strengthen their solvency position by that time.</p>
	<p>FME strengthens supervision of claims provisions with new rules</p> <p>FME is currently working on introduction of new rules for assessing claims provisions and documentation provision connected with this. References will be adopted for acceptable minimums and maximums in long-term settlement insurance classes. At least to start with, however, such references will only be set for mandatory motor vehicle insurance, since the data in smaller insurance classes, which could be considered long-term classes have not reached a sufficient level of stability to enable the calculation of serviceable reference limits.</p> <p>In addition, the rules will set out general procedures to be followed in assessing claims provisions and for information disclosure to FME, which will apply to all insurance sectors.</p> <p>In recent years FME has been of the opinion that claims provisions in mandatory motor vehicle insurance were close to the acceptable maximum. Growth in claims provisions has, however, slowed in the past year or so.</p>	

Figure 29

Profit on insurance companies' principal activities at fixed 2003 prices

The development of profits of three aspects of insurance activities from 1999-2003 at 2003 prices. Last year, non-life insurance operations and financial activities returned a greater profit than ever before, while life insurance showed only average results.

- 1999
- 2000
- 2001
- 2002
- 2003

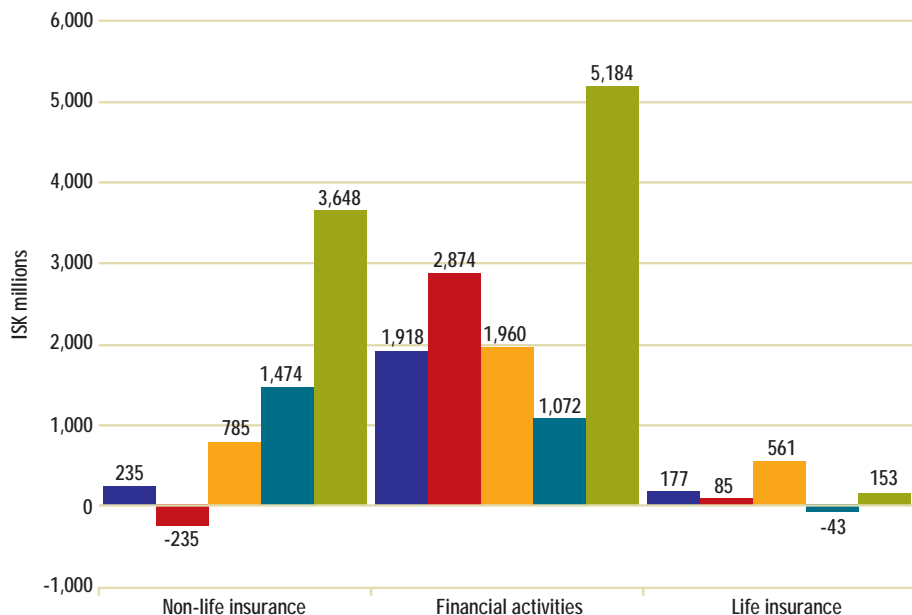


Figure 30

Share of various assets on insurance companies' balance sheets 1999-2003

The development of the shares of several items in total assets. Most notable is the increase in holdings in group and affiliated companies in 2003. The relative share of fixed-income securities and mortgages continues to drop. Reinsurers' share in technical provisions has also been dropping steadily.

- 1999
- 2000
- 2001
- 2002
- 2003

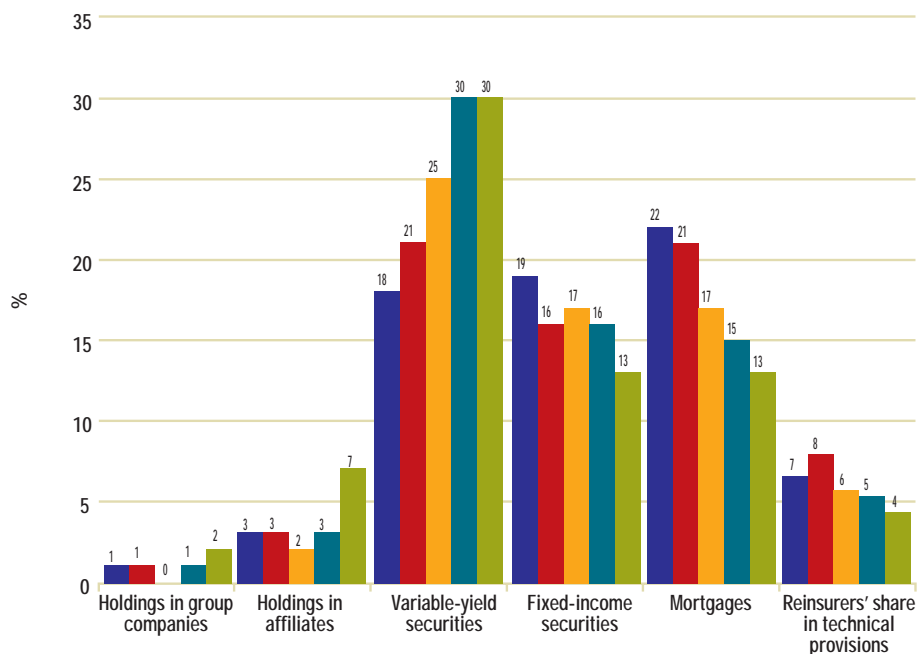
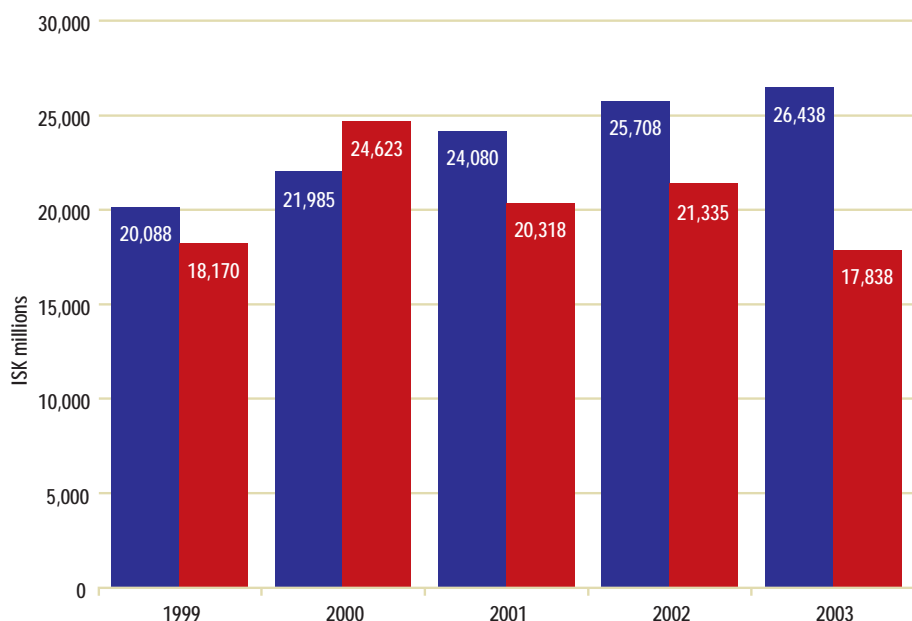


Figure 31

Premiums and claims/life insurance benefits at fixed 2003 prices

The development of premiums and claims paid by insurance companies at fixed 2003 prices. Premiums rose slightly from 2002 to 2003, but it is noteworthy that during this period claims have never been lower. In one of these years, the year 2000, claims exceeded premiums.

- Premiums
- Claims and life insurance benefits



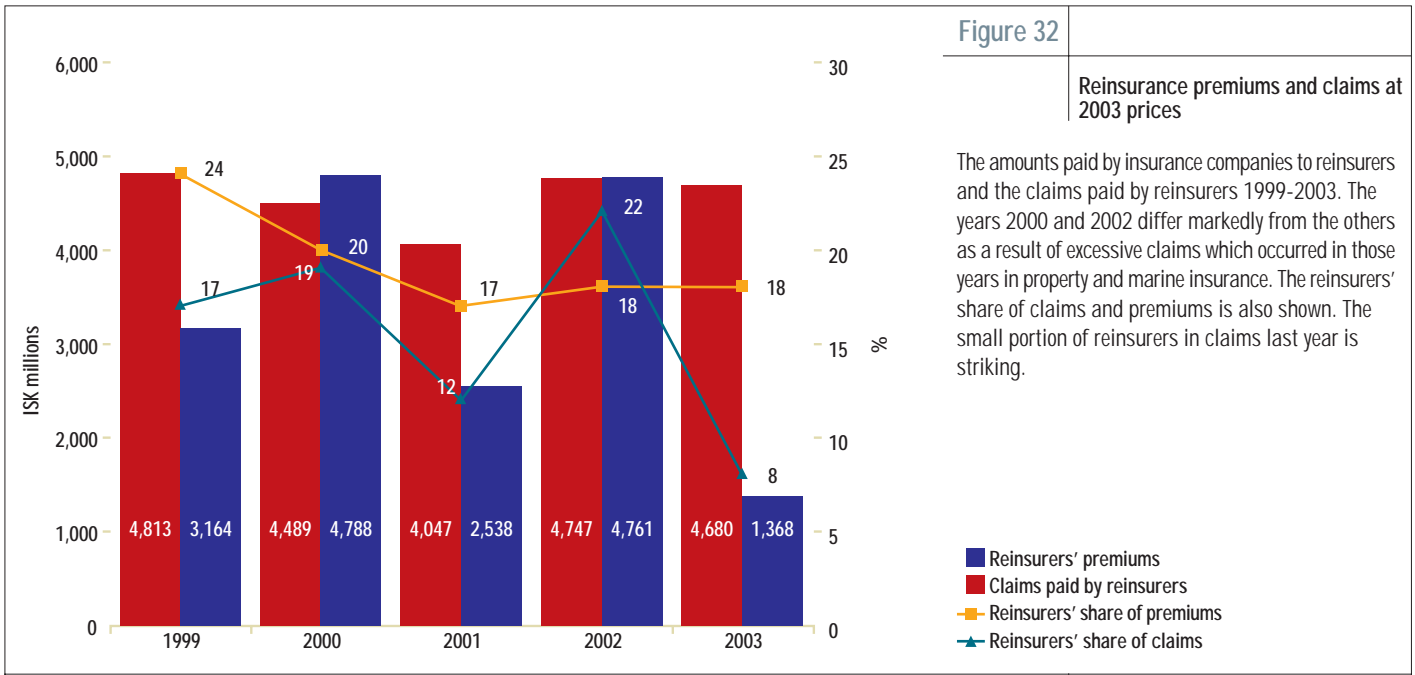


Figure 32

Reinsurance premiums and claims at 2003 prices

The amounts paid by insurance companies to reinsurers and the claims paid by reinsurers 1999-2003. The years 2000 and 2002 differ markedly from the others as a result of excessive claims which occurred in those years in property and marine insurance. The reinsurers' share of claims and premiums is also shown. The small portion of reinsurers in claims last year is striking.

■ Reinsurers' premiums
■ Claims paid by reinsurers
■ Reinsurers' share of premiums
▲ Reinsurers' share of claims

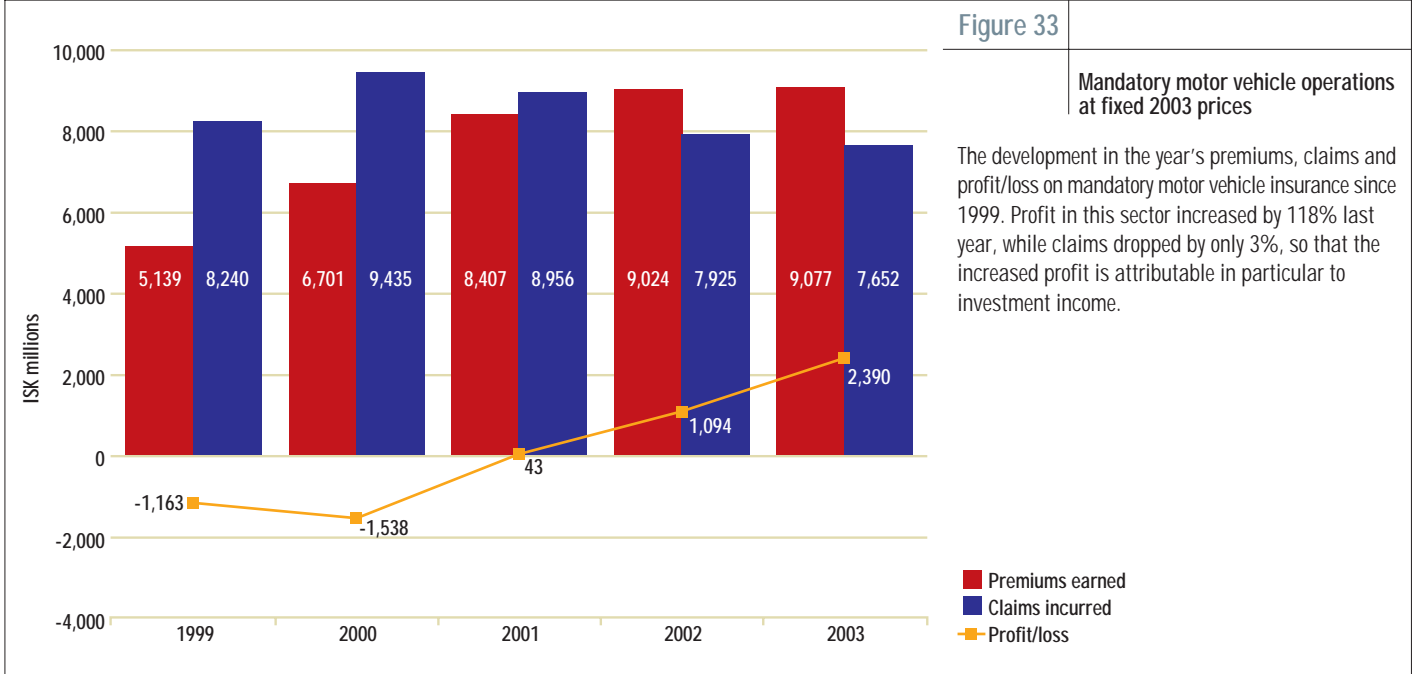


Figure 33

Mandatory motor vehicle operations at fixed 2003 prices

The development in the year's premiums, claims and profit/loss on mandatory motor vehicle insurance since 1999. Profit in this sector increased by 118% last year, while claims dropped by only 3%, so that the increased profit is attributable in particular to investment income.

■ Premiums earned
■ Claims incurred
■ Profit/loss

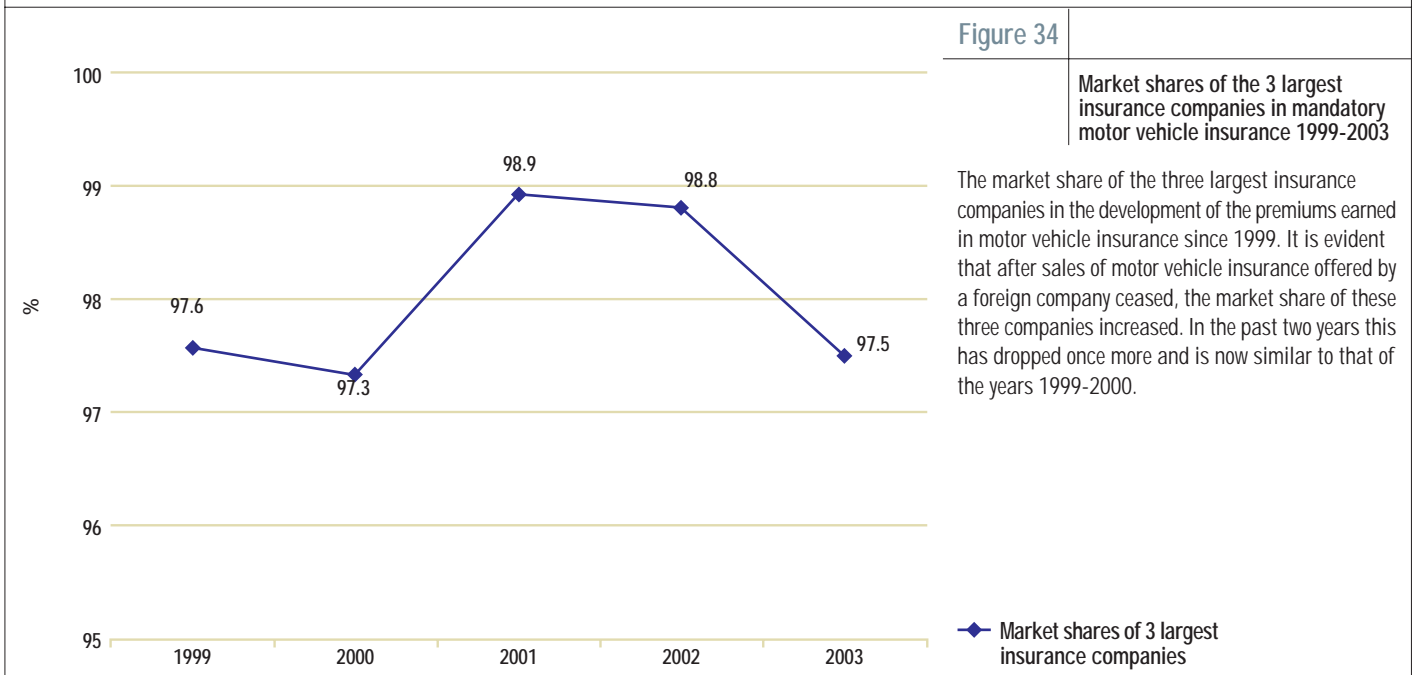


Figure 34

Market shares of the 3 largest insurance companies in mandatory motor vehicle insurance 1999-2003

The market share of the three largest insurance companies in the development of the premiums earned in motor vehicle insurance since 1999. It is evident that after sales of motor vehicle insurance offered by a foreign company ceased, the market share of these three companies increased. In the past two years this has dropped once more and is now similar to that of the years 1999-2000.

◆ Market shares of 3 largest insurance companies

Figure 35

Property insurance results at fixed 2003 prices

The outcome in property insurance 1999-2003. Premiums rose considerably in several sub sectors at the end of 2002 due to poor performance, especially in mandatory fire insurance. In 2003 claims have dropped considerably, but in spite of this the sector returned a low profit. The explanation is the relatively high operating costs and low investment income, as shown in the following figure.

■ Earned premiums
■ Incurred claims
— Profit/loss

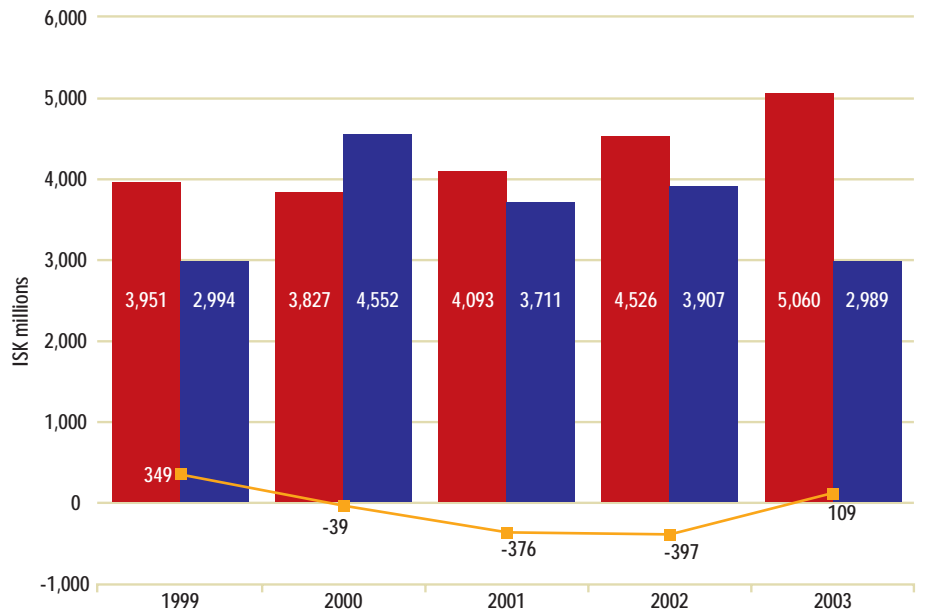


Figure 36

Operating costs and investment income as a proportion of premiums in several sectors in 2003

Premiums and claims are not a sufficient explanation for the outcome in individual sectors. Investment income is added to profit on insurance operations and operating expenses are deducted. Investment income is greatest in those sectors where technical provisions are greatest, as is the case, for example, in motor vehicle insurance. In property insurance, however, investment income is low. Operating costs comprise 12-22% of premiums.

■ Ratio of operating costs to premiums
■ Ratio of investment income to premiums

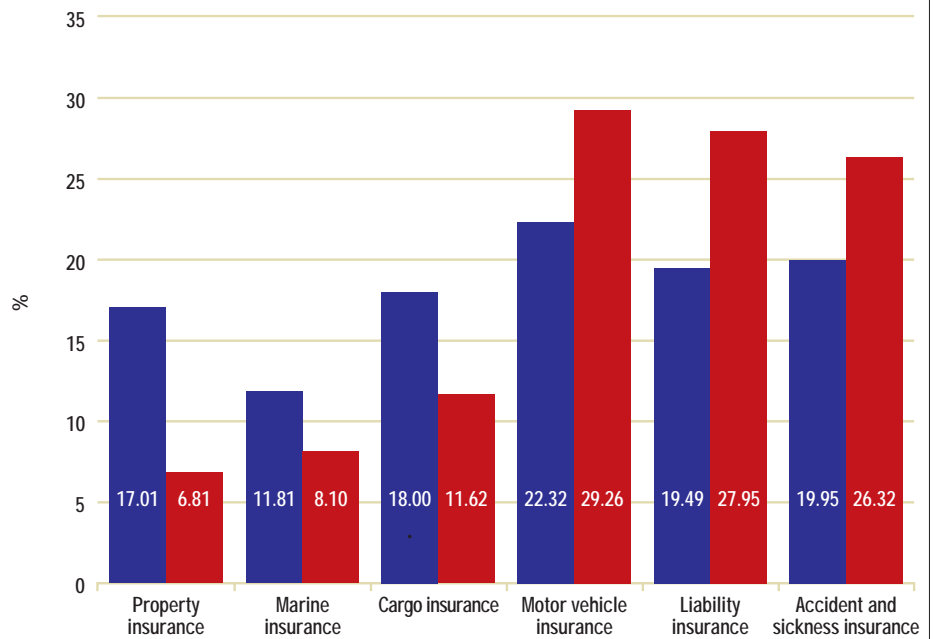
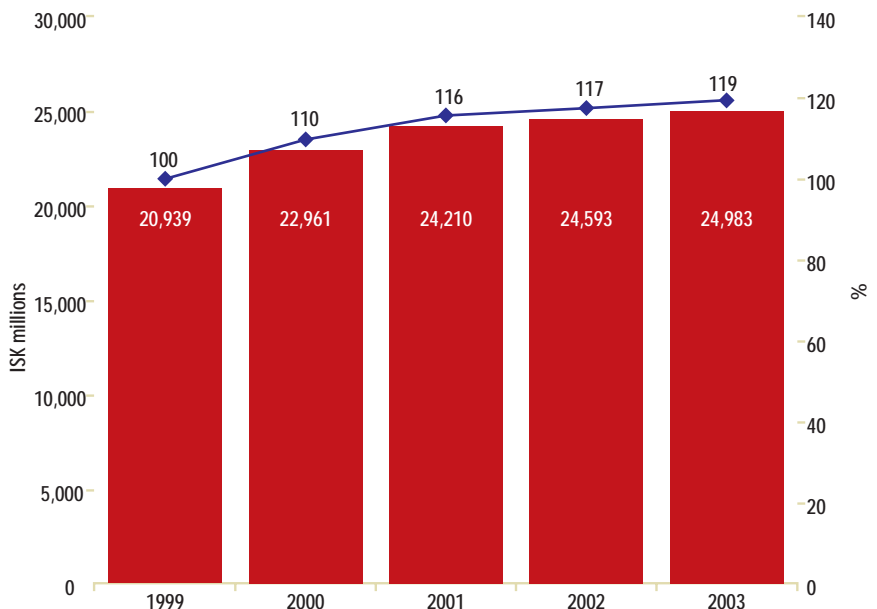


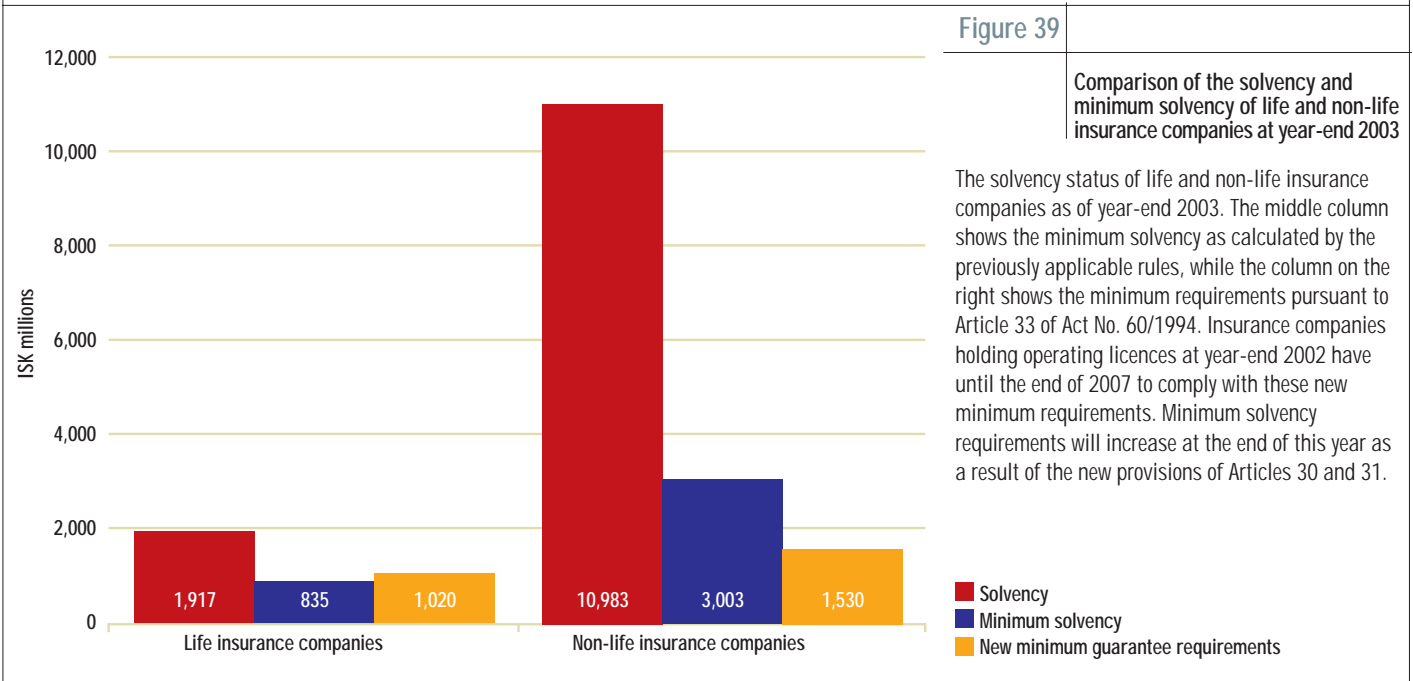
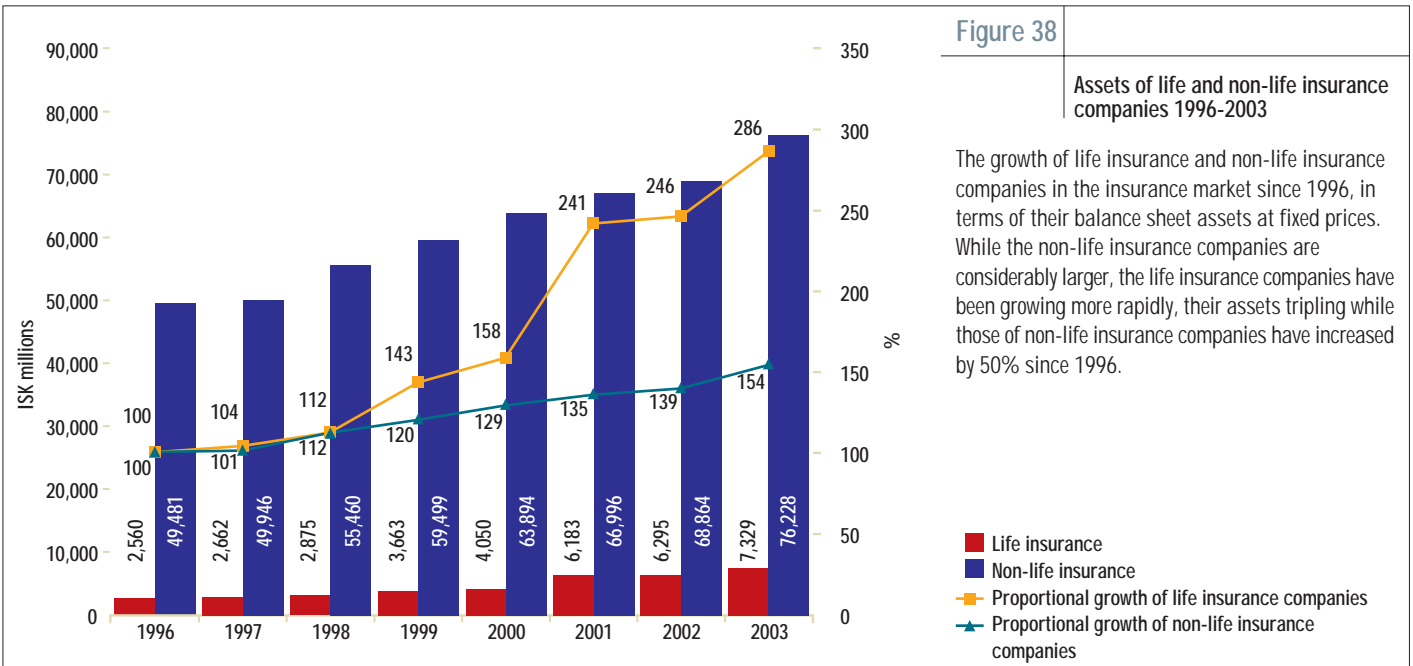
Figure 37

Provisions for claims at fixed 2003 prices - Mandatory motor vehicle insurance

The development of provisions for claims in mandatory motor vehicle insurance 1999-2003.

■ Claims provisions
◆ Development of claims provisions





3

EMPHASES IN THE FME'S WORK IN THE COMING MONTHS

The FME bases its operations on clear emphases that form the cornerstone of all its activities. These emphases have remained relatively unchanged in recent years, but the tasks for each year consist of a mixture of new activities and a continuation of previously begun projects. This chapter details a number of projects that will be embarked upon in the coming months and based on the FME's operational emphases.

3.1

Risk management and internal control

To encourage all financial undertakings to have a board and management capable of providing the company with a strong structure, clear policy, effective internal rules and work procedures, a suitable information system and internal auditing. This enables the managers themselves and other employees to correctly evaluate the risk involved in the company's activities and to manage it in accordance with the strengths of the enterprise.

Examples of general actions during the last period:

- New rules on criteria for assessing the risk of financial undertakings and a determination on higher capital adequacy ratios. Active collaboration with the managements of a number of financial undertakings regarding the implementation of the rules.
- Strengthening the supervision of risk management on a consolidated basis within international banks.
- Preparation of new rules on the technical provisions of insurance companies.

The implementation of new international rules on capital adequacy ratios (Basel II) is about to commence. One of two core features in these rules is the assessment carried out by financial supervisory authorities of the level of exposure of financial undertakings. The FME intends to **develop multifaceted risk assessment systems** to be applied in its supervision of larger financial undertakings. The new CARs also make strict requirements on the risk management systems of financial undertakings, especially those that intend to make use of a more complex capital adequacy assessment.

The FME will continue to strengthen its overview and **supervision of consolidated undertakings** in the financial market. Co-operation with supervisory institutions abroad will be reinforced in order to ensure the effective supervision of consolidated undertakings that have gained a foothold in foreign markets. Special attention will be given to operational risks involved in overseas activities.

The FME will continue to develop new methods for the supervision of risk management at all levels, for instance in its supervision of insurance

companies, but new solvency rules (Solvency II), which are partly modelled on the above-mentioned CARs for financial undertakings (Basel II), are presently under discussion within the European Union.

The FME will continue to emphasise **the strengthening and increase of on-site inspections** in all areas of the financial market. The Authority also plans to introduce **aptitude tests** for newly appointed executives in the financial market, similar to the ones that have already been designed and applied in the insurance market. Ongoing supervision of executive competence will be improved. Attention will also be paid to new risks on account of increased competition in the market for real estate loans in addition to the particular emphasis that is placed **on the supervision of large exposures**.

3.2

Conduct of business practices in the financial market

The FME monitors activities in the financial market to make sure they are in accordance with proper and sound business practices. Rapid developments in the financial market call for a constant monitoring of business conduct in order to respond to changed circumstances.

Examples of general actions during the last period:

- Levying of administrative fines for infringements of rules on insider trading.
- Examination of the conduct of boards and managements of financial undertakings.
- Formulation of guidelines on investor protection.
- Detailed examinations of the business conduct of financial undertakings in securities transactions.
- Formulation of guidelines on the participation of financial undertakings in business activities and supervision of the operating licences of insurance companies.

The FME will impose strict **administrative fines** on those who fail to comply with legal provisions concerning the treatment of insider information. The levying of administrative fines helps promote better work practices among primary insiders and issuers of securities and thus reduces the risk of actual insider fraud. The FME also wishes to emphasise the importance of giving careful consideration to authorisation

of further administrative fines on account of insider fraud and market abuse.

The securities market legislation will need to be amended during the coming months following the implementation of a number of EU directives, for instance on market fraud, prospectuses, takeovers and securities transactions. As a member of the Committee of European Securities Regulators, the FME has a duty to facilitate the effective implementation of new rules in this field in the fullest possible harmony with practices in other member states.

Guidelines on the operating **licences of insurance companies** will be formulated, including interpretations of legal provisions on this matter, which are currently a matter of some debate.

A new Act on Insurance Contracts no. 30/2004 will enter into effect at the beginning of 2006. The FME and the insurance companies will need to spend considerable time and effort next year to prepare for this event. Of a similar vein is a new directive on insurance brokerage, which must be introduced and will be implemented next year.

There will be an ongoing **supervision of the business practices** of the owners of qualifying holdings, the activities of the boards and managements of financial undertakings and insurance companies in which they have a holding, and also the conduct of financial undertakings in securities transactions.

3.3

Market discipline

The FME emphasises the need to encourage increased transparency in financial market activities. Doing so leads to increased discipline exerted by the market, accompanied by the restraints of internal control and the official supervision of financial activities.

Examples of general actions during the last period:

- Discussions on transparency in the activities of the FME.
- Preparations for the introduction of the IASB accounting standards.

Next year, all listed companies must present their consolidated financial statements in

<p>accordance with the accounting standards of the International Accounting Standards Board (IASB). The FME will play an important part in this work as a number of the largest issuers of listed securities are subject to its supervision. As a member of the CESR the FME will participate in the collaboration of financial supervisory authorities on the introduction of these standards and the supervision of financial statements based on them. The FME will also review the rules on the financial statements of financial undertakings and pension funds in terms of these standards. A review of the regulation on the annual financial statements of insurance companies will also need to be considered.</p> <p>A consensus on extending the FME's authorisation to disclose the results of its examination of individual cases in the securities market appears to be forming, but the FME called for discussions on this issue last year. It</p>	<p>seems likely that a new bill on securities transactions, which is currently under preparation, will contain increased authorisations in this respect. If the legislators decide to enhance the transparency of the FME's activities in this manner, the FME intends to establish clear procedures for its disclosure of information in order to insure harmony and effectiveness.</p>	<p>Projects to promote competitiveness will be similar to previous efforts towards this goal. Participation in the collaboration of European financial supervisory authorities encourages the harmonisation of rules concerning the financial market and homogeneity of supervisory procedures. This facilitates the operations of Icelandic enterprises abroad and may also attract the attention of foreign investors to the financial market in Iceland.</p> <p>The FME has introduced new supervisory procedures in a number of areas. Through ongoing development and supervisory initiative the FME seeks to become fully compatible with similar authorities in charge of supervision in competitive markets. This is imperative for the competitiveness of the Icelandic financial market.</p>
	<p>3.4 Competitiveness of the financial market</p> <p><i>The FME has a role to play in creating a competitive financial market in Iceland. This is done by participating in the shaping of an effective financial market and compliance with perspectives of customer interests and security in financial services.</i></p> <p>Examples of general actions during the last period:</p> <ul style="list-style-type: none"> - Contracts on collaboration with overseas financial supervisory authorities on the supervision of individual financial undertakings. - Participation in the harmonisation of supervision at European level. 	

4

PARTIES SUBJECT TO SUPERVISION

4.1

Number of parties subject to supervision

As of 30 June 2004, the number of parties subject to supervision by the Financial Supervisory Authority was as follows:

	Number 30.06.2004	Operate in accordance with Act No.
Commercial banks	4	161/2002, on Financial Undertakings
Savings banks	24	161/2002, on Financial Undertakings
Credit undertakings	9	161/2002, on Financial Undertakings
Deposit departments of co-operative societies	4	22/1991, as subsequently amended
Securities companies	6	161/2002, on Financial Undertakings
Securities brokers	3	161/2002, on Financial Undertakings
Management companies of UCITS	5	161/2002, on Financial Undertakings
UCITS (total number 10)*		30/2003, on Undertakings for Collective Investment in
Investment funds (total number 15)*		Trans-ferable Securities (UCITS) and Investment Funds
Stock exchanges and other regulated OTC markets	1	34/1998, as subsequently amended
Central securities depositories	1	131/1997, as subsequently amended
Pension funds	49	129/1997, as subsequently amended
Insurance companies	15	60/1994, as subsequently amended
Insurance brokers	17	60/1994, as subsequently amended
Other parties subject to supervision	5	Various Acts
	Total 143*	

*) UCITS and investment funds are operated by management companies. The number of those funds are not included in the total number of parties subject to supervision. Several of these funds have more than one division

4.2

Changes in the operating licences, names and number of parties subject to supervision during the period 1 July 2003 to 30 June 2004

The credit market

FME granted MP Fjárfestingarbanki hf. (MP Investment Bank Ltd.) a licence to operate as a credit undertaking on 24 October 2003, pursuant to Act No. 161/2002, on Financial Undertakings. The company was previously named MP Verðbréf hf. and operated as a securities company. Straumur Fjárfestingarbanki hf. (Straumur Investment Bank Ltd.) obtained a licence to operate as a credit undertaking on 2 January 2004, pursuant to Act No. 161/2002, on Financial Undertakings. On 15 January 2004, FME granted its consent for the merger of Íslandsbanki hf. and Glitnir hf. with the bank assuming all the latter company's rights and obligations as of 1 January 2003. Íslandsbanki hf. also assumed all the rights and obligations of Framtak Fjárfestingarbanki hf. as of 1 January 2004 but the FME authorised the merger of these companies on 7 April 2004.

The deposit department of the co-operative Kaupfélag Suðurnesja ceased operation on 31 December 2003. The departments remaining deposits were transferred to accounts with a savings bank in consultation with their owners. The deposit department of the co-operative Kaupfélag Héraðsbúa ceased operation on 1 March 2004 and deposits were transferred to accounts in a commercial bank in consultation with their owners. The operations of the deposit department of the co-operative Kaupfélag Árnesinga also ceased in May 2004 when composition was reached with creditors.

The securities market

Securities companies

The securities company MP Verðbréf hf., which had operated since 4 June 1999, was granted a licence to operate as a credit undertaking on 24 October 2003, in accordance with Act No. 161/2002, on Financial Undertakings. As of that date the name of the company was changed to MP Fjárfestingarbanki hf.

Securities brokers

On 20 February 2004 H.F. Verðbréf hf. was granted an operating licence as a securities broker in accordance with Act No. 161/2002, on Financial Undertakings. On 12 November 2003 the legal form of the securities broker Vaxta hf. was changed from a private limited-liability company to a public limited-liability company with the name Vaxta hf.

Management companies of UCITS

On 1 July 2003, Act No. 30/2003, on Undertakings for Collective Investment in Transferable Securities (UCITS) and Investment Funds, entered into force. According to the Act UCITS and investment funds must be operated by management companies which have been granted an operating licence by FME pursuant to Act No. 161/2002, on Financial Undertakings. Prior to this, management companies of UCITS were recognised by FME as provided for in an earlier Act on UCITS, No. 10/1993.

The following management companies have been granted operating licences in accordance with Act No. 161/2002, on Financial Undertakings, to operate UCITS and other funds for collective investment: Landsvaki hf. on 28 October 2003; Rekstrarfélag ÍSB hf., on 4 December 2003; Rekstrarfélag Kaupþings Búnaðarbanka hf., on 12 December 2004; Íslensk verðbréf - Eignastýring hf., on 20 January 2004; SPH Rekstrarfélag hf., on 20 February 2004. In addition to the above, Landsvaki hf. was granted an operating licence on 28 October 2003 to carry out asset management pursuant to Act No. 161/2002.

UCITS and investment funds

Act No. 30/2003, on Undertakings for Collective Investment in Transferable Securities (UCITS) and Investment Funds, entered into force on 1 July 2003. According to this Act, UCITS must be established and operated by management companies instead of being independent legal entities, i.e. limited-liability companies, as provided for in the previous Act on UCITS, No. 10/1993. Under the new Act, FME is to approve those UCITS and investment funds issuing unit share certificates and grant licences to management funds issuing shares.

<p>The individual UCITS and investment funds, together with fund divisions, if applicable, which have received FME's approval in accordance with the above, are listed under their respective management companies in the list of parties subject to supervision in this Report.</p> <p>Pension funds The pension fund, Tryggingarsjóður lækna, is not included on the list of pension funds in this Report. The fund was placed in the hands of a special winding-up committee appointed by the Minister of Finance at the beginning of 2003. The pension funds Séreignalífeyrissjóðurinn and Frjálsi Lífeyrissjóðurinn were merged as of 1 April 2004 under the name Frjálsi lífeyrissjóðurinn.</p> <p>The Insurance Market</p> <p>Insurance companies On 17 December 2003 the name of Sameinaða líftryggingarfélagið hf. was changed to Sjóvá-Almennar líftryggingar hf. On 30 December 2003 the Minister of Commerce granted the company, European Risk Insurance Company hf., a licence to operate as an insurance company in sector 13, general liability insurance. On 3 March 2004, Vörður Vátryggingafélag hf. received a licence for certain sectors of non-life insurance. The company concurrently took over the insurance portfolio of Vörður vátryggingarfélag g.t., which ceased insurance activities.</p> <p>Insurance brokers FME listed the company UIB Nordic AB in its Register of Insurance Brokers on 27 August 2003. On 2 June 2004, the company Besso Limited, was withdrawn from the Register of Insurance Brokers at its request.</p> <p>The Minister of Commerce granted TS Tryggingarráðgjöf hf. a licence to operate as an insurance broker in Iceland on 27 January 2004; the licence was subsequently returned to the Ministry on 25 May 2004. The Minister of Commerce granted Vilhelmina S. Kristinsdóttir a licence to operate as an insurance broker in Iceland on 13 May 2004.</p> <p>The following companies turned in their licences to operate as insurance brokers to the Minister of Commerce during the period: Tryggingastofan ehf., on 18 August 2003; Alþjóðleg miðlun ehf., on 19 August 2003; Tryggingaþjónustan ehf., on 7 April 2004; and Alþjóða fjárfestinga- og vátryggingamiðlunin ehf., on 13 April 2004.</p> <p>The following individuals turned in their licences to operate as insurance brokers: Leo Árnason, on 18 August 2003.</p>	<p>4.3 List of parties subject to supervision as of 30 June 2004</p> <p>COMMERCIAL BANKS Head office</p> <p>Íslandsbanki hf. Reykjavík Kaupþing Búnaðarbanki hf. Reykjavík Landsbanki Íslands hf. Reykjavík Sparisjóðabanki Íslands hf. Reykjavík</p> <p>SAVINGS BANKS</p> <p>nb.is-sparisjóður hf. Reykjavík Sparisjóður Bolungarvíkur Bolungarvík Sparisjóður Hafnarfjarðar Hafnarfjörður Sparisjóður Hornafjarðar og nágrennis Höfn Sparisjóður Hólahrepps Sauðárkrókur Sparisjóður Húnaþings og Stranda Hvammstangi Sparisjóður Höfðhverfinga Grenivík Sparisjóður Kaupþings hf. Reykjavík Sparisjóður Kópavogs Kópavogur Sparisjóður Mýrasýslu Borgarnes Sparisjóður Norðfjarðar Neskaupstaður Sparisjóður Norðlendinga Akureyri Sparisjóður Ólafsfjarðar Ólafsfjörður Sparisjóður Ólafsvíkur Ólafsvík Sparisjóður Reykjavíkur og nágrennis Reykjavík Sparisjóður Siglufjarðar Siglufjörður Sparisjóður Strandamanna Hólmavík Sparisjóður Suður-Þingeyinga Laugar Sparisjóður Svarfdæla Dalvík Sparisjóður Vestfirðinga Þingeyri Sparisjóður Vestmannaeyja Vestmannaeyjar Sparisjóður vélstjóra Reykjavík Sparisjóður Þórshafnar og nágrennis Þórshöfn Sparisjóðurinn í Keflavík Keflavík</p> <p>CREDIT UNDERTAKINGS</p> <p>Byggðastofnun Reykjavík Frjálsi fjárfestingarbankinn hf. Reykjavík Greiðslumiðlun hf. - VISA Ísland Reykjavík Kreditkort hf. - EUROPAY Ísland Reykjavík Lánasjóður landbúnaðarins Selfoss Lýsing hf. Reykjavík MP Fjárfestingarbanki hf. Reykjavík SP-Fjármögnun hf. Reykjavík Straumur Fjárfestingarbanki hf. Reykjavík</p> <p>DEPOSIT DEPARTMENTS OF CO-OPERATIVE SOCIETIES</p> <p>Kaupfélag Austur-Skaftfellinga Höfn Kaufélag Fáskrúðsfirðinga Fáskrúðsfjörður Kaufélag Skagfirðinga Skagafjörður Kaufélag V-Húnavetninga Hvammstangi</p> <p>SECURITIES COMPANIES</p> <p>Arion verðbréfavarsla hf. Reykjavík Fjarvernd – Verðbréf hf. Reykjavík Íslensk verðbréf hf. Akureyri Jöklar – Verðbréf hf. Reykjavík Verðbréfastofan hf. Reykjavík Virðing hf. Reykjavík</p>
<p>Other parties subject to supervision</p> <p>Act No. 57/2004, amending the Housing Act, No. 44/1998, as subsequently amended, which entered into force on 1 July 2004, provides for FME to supervise the activities of Íbúðalánasjóður (the Housing Financing Fund) and ensure they comply with the provisions of the Act. Prior to the amendment, FME's supervisory role included only the housing bond division of the fund.</p>	

SECURITIES BROKERAGES	Head office	Rekstrarfélag ÍSB hf. (Management company)	Reykjavík
H.F. Verðbréf hf.	Reykjavík	Verðbréfasjóðir ÍSB (<i>UCITS and its departments</i>)	
Íslenskir fjárfestar hf.	Reykjavík	Sjóður 1 – íslensk skuldabréf	
Vaxta hf. verðbréfamiðlun	Kópavogur	Sjóður 5 – ríkisskuldabréf	
		Sjóður 6 – hlutabréf á aðallista	
		Sjóður 7 – húsbref	
		Sjóður 9 – peningamarkaðsbref	
		Sjóður 11 – löng skuldabréf	
		Sjóður 12 – ÍSB heimssafn	
		Sjóður 19 – ÍSB fjármál	
		Sjóður 20 – ÍSB heilsa	
		Sjóður 21 – ÍSB lífsstill	
		Sjóður 22 – ÍSB tækni	
		Fjárfestingarsjóður Íslandsbanka (<i>Investment fund and department</i>)	
		Sjóður 10 – úrval innlendra hlutabréfa	
MANAGEMENT COMPANIES OF UCITS (UCITS and investment funds operated by them)		SPH Rekstrarfélag hf. (Management company)	Reykjavík
Íslensk verðbréf – Eignastýring hf. (Management company)	Akureyri	SPH Verðbréfasjóðurinn (<i>UCITS and its departments</i>)	
Verðbréfasjóður ÍV (<i>UCITS and its departments</i>)		Fjármálasjóðurinn	
Verðbréf 1 - ríkisskuldabréf		Hátækni sjóðurinn	
Verðbréf 2 - skuldabréf		Úrvalssjóðurinn	
Verðbréf 3 - peningamarkaður		Skuldabréfasjóðurinn	
Verðbréf 4 - hlutabréf		Alþjóðasjóðurinn	
Verðbréf 5 - heimasjóður		Lyf- og líftækni sjóðurinn	
Verðbréf 6 – alþjóðlegur sjóður			
Fjárfestingarsjóðir ÍV (<i>Investment fund and department</i>)			
Hlutabréfasjóður ÍV			
Landsvaki hf. (Management company)	Reykjavík		
Landsjóður (<i>UCITS and its departments</i>)			
Skuldabréfedeild			
Reiðubréfedeild			
Markaðsbrefedeild 1			
Markaðsbrefedeild 2			
Markaðsbrefedeild 3			
Markaðsbrefedeild 4			
Sparibrefedeild			
Landsbanki Global Equity Fund			
Fjárvörsludeild 1			
Fjárvörsludeild 2			
Fjárvörsludeild 3			
Fjárvörsludeild 4			
Fjárvörsludeild 5			
Fjárvörsludeild 6			
Visitölubréf			
Landsjóður2 (<i>Investment fund and department</i>)			
Fyrirtækjabrefedeild			
Peningabréf			
Úrvalsbrefedeild			
Rekstrarfélag Kaupþings Búnaðarbanka hf. (Management company)	Reykjavík		
Kjarabréf (<i>UCITS</i>)			
Markbréf	“		
Ríkisverðbréfasjóður langur	“		
Ríkisverðbréfasjóður millilangur	“		
Úrvalsvitölusjóður	“		
Áskriftarsjóður ríkisverðbréfa	“		
Eignastýringasjóður (<i>Investment fund</i>)			
Einingabréf 9	“		
Hávaxtasjóður	“		
ÍS-15	“		
Íslensk skuldabréf skammtíma	“		
Íslensk skuldabréf langtíma	“		
Peningamarkaðssjóður	“		
Skammtímasjóður	“		
Ævileið 1	“		
Ævileið 2	“		
Ævileið 3	“		
Ævileið 4	“		
		STOCK EXCHANGES AND REGULATED OTC MARKETS	
		Iceland Stock Exchange Ltd.	Reykjavík
		CENTRAL SECURITIES DEPOSITORIES	
		The Icelandic Securities Depository	Reykjavík
		PENSION FUNDS	
		Almenni lífeyrissjóðurinn	Reykjavík
		Eftirlaunasjóður F.Í.A.	Reykjavík
		Eftirlaunasjóður Reykjanesbæjar	Keflavík
		Eftirlaunasjóður Sláturfélags Suðurlands	Reykjavík
		Eftirlaunasjóður slökkviliðsmanna á Keflavíkurflugvelli	Keflavík
		Eftirlaunasjóður starfsmanna Hafnarfjarðarkaupstaðar	Hafnarfjörður
		Eftirlaunasjóður starfsmanna Íslandsbanka hf.	Reykjavík
		Eftirlaunasjóður starfsmanna Ólíuverzlunar Íslands	Reykjavík
		Eftirlaunasjóður starfsmanna Útvegsbanka Íslands	Reykjavík
		Frjálsi lífeyrissjóðurinn	Reykjavík
		Íslenski lífeyrissjóðurinn	Reykjavík
		Lífeyrissjóður Akraneskaupstaðar	Akranes
		Lífeyrissjóður Austurlands	Neskaupstaður
		Lífeyrissjóður bankamanna	Reykjavík
		Lífeyrissjóður Bolungarvíkur	Bolungarvík
		Lífeyrissjóður bænda	Reykjavík
		Lífeyrissjóður Hf. Eimskipafélags Íslands	Reykjavík
		Lífeyrissjóður Flugvirkjafélags Íslands	Reykjavík
		Lífeyrissjóður hjúkrunarfræðinga	Reykjavík
		Lífeyrissjóður lækna	Reykjavík
		Lífeyrissjóður Mjólkursamsölnunnar	Reykjavík
		Lífeyrissjóður Neskaupstaðar	Reykjavík
		Lífeyrissjóður Norðurlands	Akureyri
		Lífeyrissjóður Rangæinga	Hella
		Lífeyrissjóður sjómanna	Reykjavík
		Lífeyrissjóður starfsmanna Akureyrarbæjar	Akureyri

Lífeyrissjóður starfsmanna Áburðarverksmiðju ríkisins	Reykjavík	Insurance brokers covered by Professional Liability Insurance of Insurance Brokers
Lífeyrissjóður starfsmanna Búnaðarbanka Íslands hf.	Reykjavík	
Lífeyrissjóður starfsmanna Húsavíkurkaupstaðar	Reykjavík	
Lífeyrissjóður starfsmanna Kópavogsbæjar	Kópavogur	
Lífeyrissjóður starfsmanna Reykjavíkrapóteks	Reykjavík	
Lífeyrissjóður starfsmanna Reykjavíkurborgar	Reykjavík	
Lífeyrissjóður starfsmanna ríkisins	Reykjavík	
Lífeyrissjóður starfsmanna sveitarfélaga	Reykjavík	
Lífeyrissjóður starfsmanna Vestmannaeyjabæjar	Vestmannaeyjar	
Lífeyrissjóður Suðurlands	Selfoss	
Lífeyrissjóður Suðurnesja	Keflavík	
Lífeyrissjóður Tannlæknafélags Íslands	Reykjavík	
Lífeyrissjóður verkfræðinga	Reykjavík	
Lífeyrissjóður verslunarmanna	Reykjavík	
Lífeyrissjóður Vestfirðinga	Ísafjörður	
Lífeyrissjóður Vestmannaeyja	Vestmannaeyjar	
Lífeyrissjóður Vesturlands	Akranes	
Lífeyrissjóðurinn Framsýn	Reykjavík	
Lífeyrissjóðurinn Lífiðn	Reykjavík	
Lífeyrissjóðurinn Skjöldur	Reykjavík	
Sameinaði lífeyrissjóðurinn	Reykjavík	
Samvinnulífeyrissjóðurinn	Reykjavík	
Söfnunarsjóður lífeyrisréttinda	Reykjavík	
INSURANCE COMPANIES		OTHER PARTIES SUBJECT TO SUPERVISION
Alþjóða líftryggingarfélagið hf.	Reykjavík	
European Risk Insurance Company hf.	Reykjavík	
Íslandstrygging hf.	Reykjavík	
Íslensk endurtrygging hf.	Reykjavík	
Líftryggingamiðstöðin hf.	Reykjavík	
Líftryggingafélag Íslands hf.	Reykjavík	
Sjóvá-Almennar líftryggingar hf.	Reykjavík	
Sjóvá-Almennar tryggingar hf.	Reykjavík	
Trygging hf.	Reykjavík	
Tryggingamiðstöðin hf.	Reykjavík	
Vátryggingafélag Íslands hf.	Reykjavík	
Vélbátaábyrgðarfélagið Gróttta g.t.	Reykjavík	
Vélbátaábyrgðarfélag Ísfirðinga g.t.	Ísafjörður	
Viðlagatrygging Íslands	Reykjavík	
Vörður Vátryggingafélag hf.	Akureyri	
INSURANCE BROKERAGES		<p>4.4 Activities of foreign financial undertakings in Iceland</p> <p>Pursuant to the legal framework established by the Agreement on a European Economic Area, various foreign financial undertakings, i.e. credit institutions, UCITS, various funds, investment firms and insurance companies, may offer their services in Iceland on the basis of an operating licence granted in their home state. The numbers of foreign parties who have given notice that they intend to offer services in Iceland pursuant to the above are as follows:</p> <p>Foreign banks 95 UCITS 35 Other funds 8 Investment firms 680 Insurance companies with an establishment 2 Insurance companies without an establishment 204</p>
Aon Limited	London	
Árni Reynisson ehf.	Reykjavík	
DDF Vátryggingamiðlunin ehf.	Reykjavík	
Fjárfestingarmiðlun Íslands ehf.	Kópavogur	
Heath Lambert Norway AS	Osló	
Howden Insurance Brokers Ltd.	London	
Marsh Ltd.	London	
Nýja vátryggingaþjónustan ehf.	Reykjavík	
Olaf Forberg	Kópavogur	
Provins Insurance AB	Svíþjóð	
Trygg miðlun ehf.	Reykjavík	
Tryggingamiðlun Íslands ehf.	Reykjavík	
Tryggingamiðlun Reykjavíkur ehf.	Reykjavík	
Tryggingar og ráðgjöf ehf.	Reykjavík	
UIB Nordic AB	Svíþjóð	
Vilhelmina S. Kristinsdóttir	Reykjavík	
Willis AB	Stokkhólmur	

5

AMENDMENTS TO ACTS AND REGULATIONS

5.1 General

Act No. 99/1999, on payment of Cost due to Official Supervision of Financial Activities

Amendments:

- Act No. 137/2003: The percentage of the supervision fee, provided for in Article 5 of Act No. 99/1999, is changed to reflect FME's estimated operating costs, cf. Article 2 of Act No. 99/1999.

5.2 The credit market

Act No. 161/2002, on Financial Undertakings

Amendments:

- Act No. 4/2004: The Act amends Chapter VIII of the Act on Savings Banks. The amendments concern, for instance, provisions on a self-governing foundation, which is to be established under the Act when a decision has been taken to transform a savings bank into a limited-liability company, e.g. with regard to the composition of the board of directors of such foundations. Furthermore, changes were made to provisions on mergers of savings banks.

Act No. 61/1997, on the New Business Venture Fund

Amendments:

- Act No. 92/2004: The Act amends the General Provisions in Chapter I of the Act. The amendments concern, for instance, the authorisation of the New Business Venture Fund to contribute funds from its initial fund to venture funds, together with other investors.

Regulation No. 244/2004 authorising financial institutions and subsidiaries of credit institutions established in another state of the European Economic Area to pursue financial activities in Iceland (244/2004).

This Regulation authorises joint subsidiaries of two or more credit institutions to carry out payment card transactions and services in Iceland, providing they fulfil certain conditions. Joint subsidiaries refers to companies as described in Article 19 of Directive 2000/12/EC, relating to the taking up and pursuit of the business of credit institutions. The Regulation is also intended to transpose the provisions of Directive 2000/12/EC concerning authorisations of undertakings connected with the financial sector and subsidiaries of credit institutions, or joint subsidiaries of two or more credit institutions, to operate in the European Economic Area, and provisions of Directive 93/22/EC, on investment services in the securities field, concerning information which FME is to provide to competent authorities of host states concerning amendments to investors' compensation schemes.

Rules No. 834/2003, on the financial statements of credit institutions

These Rules replace the Rules on annual accounts of credit institutions, No. 692/2001, and the Rules on interim statements of credit institutions, No. 691/2001. The Rules include amendments presented in Discussion Paper No. 1/2003 concerning, firstly, increased information disclosure on remuneration to Boards of Directors and Managing Directors; secondly, information disclosure on remuneration to external auditors; and thirdly, more restrictive rules on depreciation, having regard to International Financial Reporting Standard No. 39.

Rules No. 530/2004, on FME's criteria for assessing the exposure of financial undertakings and decisions on capital adequacy ratios above the statutory minimum

The Rules provide for the implementation of a recent authorisation in the second paragraph of Article 84 of Act No. 161/2002, on Financial Undertakings, to set a higher capital adequacy ratio than the mandatory 8% for individual financial undertakings. The Rules are based on a special risk assessment system and stress test developed by FME and applied as part of its supervision in recent years.

5.3 The securities market

Act No. 161/2002, on Financial Undertakings

Amendments:

- Act No. 4/2004: The Act amends Chapter VIII of the Act on Savings Banks. The amendments concern, for instance, provisions on a self-governing foundation, which is to be established under the Act when a decision has been taken to transform a savings bank into a limited-liability company, with regard to the composition of the board of directors of such foundations. Furthermore, changes were made to provisions on mergers of savings banks.

Act on Undertakings for Collective Investment in Transferable Securities (UCITS) and Investment Funds (30/2003)

The Act includes amendments to the Directive on Collective Investment in Transferable Securities as well as changes intended to create a more favourable environment for the operating of funds for collective investment in Iceland and encourage more effective consumer protection.

Act No. 33/2003, on Securities Transactions

The Act provides comprehensive legislation including rules of behaviour on the securities market and provisions on the rights and obligations of financial undertakings holding licences to carry out securities transactions. The provisions of the Act are based on the foundation laid by the previous Act on Securities Transactions, No. 13/1996, and Act on the Activities of Stock Exchanges and Regulated OTC Markets, No. 34/1998.

5.4 Pension funds

Act No. 129/1997, on Mandatory Guarantee of Pension Rights and the Operations of Pension Funds.

Amendments:

- Act No. 70/2004: This Act amends Act No. 129/1997. It authorises foreign commercial banks, savings banks, securities enterprises and life insurance companies, established and holding an operating licence in another state of the European Economic Area or member state of the European Free Trade Association (EFTA) Treaty, upon fulfilment of certain conditions, to offer services pursuant to Chapter II of the Act, i.e. to accept premiums under agreements for supplementary insurance cover. Furthermore, changes were made to Article 36 of the Act concerning investment authorisations of pension funds.

5.5 The Insurance Market

Act No. 30/2004, on Insurance Contracts

- Act No. 30/2004: The Act will come into effect as of 1 January 2006. The Act shall apply to all new insurance contracts concluded as of that date, all insurance contracts renewed or extended as of that date, and all other insurance contracts in force on that date. Upon the entry into force of the Act, the Act on Insurance Contracts, No. 20/1954, shall be repealed. The Act will also result in changes to the Act on Insurance Activities No. 60/1994, as several provisions of this Act will be transferred unchanged to the Act on Insurance Contracts.

5.6 FME Guidelines

FME has issued general guidelines in a number of areas of the financial market. These Guidelines are issued by virtue of legal authority in the second paragraph of Article 8 of Act No. 87/1998 on Official Supervision of Financial Activities.

This provision authorises FME to issue and publish general guidelines on the activities of parties subject to supervision, provided that their substance concerns a group of parties subject to supervision.

Guidelines no. 2/2003, on the interpretation and implementation of Regulation No. 698/1998, on the disposition of premiums for pension savings and supplementary insurance cover.

The Guidelines are intended to increase homogeneity and consistency in the implementation of the above-mentioned Regulation, and to ensure that such implementation conforms to proper and sound business practices. The Guidelines apply to all parties authorised to accept premiums under an agreement for supplementary insurance cover.

Guidelines no. 3/2003, on research analysts

These FME Guidelines set out references for what can be considered proper and sound business practices of financial undertakings in making public their analyses and investment advice. The Guidelines are issued to increase trust in the financial market and the credibility of the market in general. FME Guidelines no.1/2001 are to some extent connected with these Guidelines, as they concern primarily conflicts of interest and credibility.

Guidelines no. 4/2003, concerning exemptions from the required operation of auditing departments by financial undertakings.

Pursuant to Article 16 of Act No. 161/2002, on Financial Undertakings, financial undertakings other than electronic money undertakings and securities brokers must operate an auditing department responsible for internal auditing. According to the same provision, the Financial Supervisory Authority may, having regard to the nature and scope of the operation, grant an exemption from the operation of such an auditing department and set conditions for undertakings granted such exemptions. The Guidelines set out the references which FME will use in deciding whether to grant an exemption from the operation of an auditing department to financial undertakings and what conditions will be set for granting such an exemption.

Guidelines no. 5/2003, on the separation of management and depository operations and the independence of management companies of mutual funds, pursuant to Article 103 of Act No. 30/2003, on Undertakings for Collective Investment in Transferable Securities (UCITS) and Investment Funds.

In view of the fact that management companies of mutual funds are independent legal entities and independent financial undertakings, the Guidelines lay down detailed requirements concerning the independence and activities of management companies and their separation from depositories or other financial undertakings within the same group.

Guidelines no. 6/2003, on working practices of insurance company salesmen

These Guidelines are aimed at placing similar demands on employees of insurance companies as are made of employees of insurance brokers, with such exceptions as are applicable in each instance, having regard to the nature of each type of operations. Their principal objective is to help ensure that working practices of insurance company employees will be in accordance with proper and sound business practices.

Guidelines no. 1/2004, on the participation of commercial banks, savings banks and credit undertakings in commercial operations and their operating licences pursuant to Articles 20-22 of Act No. 161/2002, on Financial Undertakings.

The Guidelines are intended in particular to clarify the legal authorisations of these enterprises to participate in unrelated commercial operations, to prescribe proper procedures for decisions on such participation and to establish better supervision and information disclosure to the Board of Directors and FME. The Guidelines are based on Discussion Paper no. 11/2003, published on 29 October 2003 and adopted in light of experience of reporting to FME which was introduced concurrent to the publication of the Discussion Paper. In addition, regard was had for comments and suggestions by parties delivering an opinion in the issuing of the Guidelines.

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